The Aggregate Effects of Acquisitions on Innovation and Economic Growth*

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Abstract

Large incumbent firms routinely acquire startups. The effect of these acquisitions on innovation and productivity growth is a priori unclear. On the one hand, acquisitions provide an incentive for startup creation, and a way to transfer ideas to potentially more efficient users. On the other hand, incumbents might "kill" some ideas of their targets, and acquisitions may create a less competitive environment with lower incentives for innovation. Our paper quantitatively assesses the net effect of these forces. To do so, we build an endogenous growth model with heterogeneous firms and acquisitions. We discipline the model by matching micro-level evidence on startup acquisitions and patenting. Our calibrated model implies that acquisitions do raise the startup rate, but lower incumbents' own innovation as well as the percentage of implemented startup ideas. The negative forces are slightly stronger. Thus, a startup acquisition ban would increase growth by 0.04 percentage points per year.

Keywords: Acquisitions, Innovation, Productivity growth, Firm dynamics.

JEL Classification: O30, O41, E22.

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1 Introduction

Large incumbent firms routinely acquire startups. For instance, the Tech giants Amazon, Apple, Facebook, Google and Microsoft have acquired at least 770 firms since their foundation.[1] Moreover, even though Tech acquisitions have recently captured the headlines, startup acquisitions are common in other industries as well.

Startup acquisitions are, however, viewed with increasing scepticism by regulators. In the United States, the Federal Trade Commission (FTC) recently announced an inquiry into several high-profile cases, and subsequently filed lawsuits against Facebook and Google.[2] While these inquiries traditionally focus on competition and prices, regulators have recently also started to worry about the effects of startup acquisitions on innovation. However, these effects are not obvious a priori. On the one hand, acquirers may choose to sideline startup innovations that threaten their existing business, and this could slow down productivity growth. On the other hand, the prospect of being acquired may stimulate startup creation, and actual acquisitions could improve the allocation of ideas between firms, which might accelerate productivity growth. Finally, acquisitions lower competition, which has ambiguous effects on innovation and growth.

In this paper, we aim to assess the relative strength of these forces. To do so, we develop a Schumpeterian growth model with heterogeneous firms and acquisitions. We discipline the model by matching important patterns of acquisitions and patenting in the United States, including some new empirical evidence on the effect of acquisitions on the implementation probability of startup ideas. Our calibrated model implies that the negative forces slightly dominate, so that reducing the frequency of acquisitions (e.g., through stricter antitrust enforcement) would lead to a modest increase in aggregate productivity growth.[3]

Our model builds on the Schumpeterian endogenous growth framework. Each incumbent firm produces a differentiated product, and seeks to innovate in order to increase its productivity. A large mass of non-producing startups, in turn, seeks to innovate in order to displace incumbents and enter the market. We introduce two novel elements into this setting. First, we distinguish between invention and implementation. That is, all firms first need to invest into invention (or research) in order to come up with an idea. After obtaining an idea, they then need to invest additional resources to implement it. Second,

[1] See https://www.cbinsights.com/research/tech-giants-billion-dollar-acquisitions-infographic/. Between 2015 and 2017 alone, these five firms did 175 acquisitions (Gautier and Lamesch, 2020).

[2] See https://www.ftc.gov/news-events/press-releases/2020/02/ftc-examine-past-acquisitions-large-technology-companies. The FTC sued Google and Facebook in October and December 2020.

[3] Note that startup acquisitions are currently virtually unregulated. Indeed, as most of them have a relatively low deal value, they do not need to be reported to antitrust authorities (Wollmann, 2019).

we allow for startup acquisitions: when a startup has developed an idea that could displace an incumbent, the incumbent might be able to avoid this outcome by acquiring the startup. However, incumbents are not automatically able to acquire all threatening startups. Instead, their ability to acquire depends on their effort in monitoring the startup scene.

The model reflects the multiple channels through which acquisitions affect innovation and aggregate growth. Some of these channels suggest a negative link. First, incumbents have an incentive to acquire startups in order to preserve their existing profits. However, precisely because they already earn some profits, their marginal benefit from implementing a startup idea is smaller than the one of the startup itself (this is the classical replacement effect first discussed in Arrow, 1962). Thus, some ideas which would have been implemented in the absence of an acquisition might now be shelved. Such events are sometimes called "killer acquisitions" (a term coined by Cunningham, Ederer and Ma, 2020). Second, all else equal, acquisitions slow down creative destruction, by allowing incumbents to avoid displacement more frequently. This creates an economy populated by entrenched incumbents, which have high productivity advantages over their competitors and therefore low innovation incentives.

Other channels instead suggest a positive link between startup acquisitions and growth. First, incumbents might be more efficient at implementing ideas than startups (due to economies of scale and scope, a larger customer base, greater business experience, etc.). When this is the case, acquisitions transfer innovations to more efficient users, and might increase the number of ideas that are successfully implemented.[4] Second, the prospect of an acquisition provides an incentive for startup creation and startup innovation. In our model, acquisitions only occur if the incumbent pays the startup a price that exceeds its outside option of independent entry. Thus, all else equal, incentives for startup creation are higher in the presence of acquisitions. In the business world, many commentators see acquisitions as a natural outcome for startups, and numerous guides advise entrepreneurs how to position their startup in order to be acquired.[5] Finally, startup acquisitions increase the expected lifespan of incumbents, and this increases their innovation incentives. Thus, the effect of lower competition on innovation is actually ambiguous, as famously argued by Aghion, Bloom, Blundell, Griffith and Howitt (2005).[6]

[4]Indeed, this might reflect a beneficial division of labor, with startups specializing in generating ideas and incumbents specializing in implementing them. Likewise, acquisitions might enable startup founders to focus on their core strengths instead of having to deal with management and organizational problems (see https://time.com/3815612/silicon-valley-acquisition for a discussion of these issues).

[5]For some examples, see (1) https://www.forbes.com/sites/alejandrocremades/2019/08/02/how-to-get-your-business-acquired, (2) https://www.inc.com/john-boitnott/how-to-boost-your-businesss-odds-of-an-acquisition or (3) https://thinkgrowth.org/how-to-build-a-startup-that-gets-acquired-85ada592bfd7.

[6]Another effect that we do not explore in our paper is that acquisitions reallocate employees and researchers.

To discipline the different forces in our model, we rely on two data sources. First, we use a database assembled by Guzman and Stern (2020), which covers the universe of startups in 32 US states between 1988 and 2008. This database provides some information of the frequency with which startups are acquired (or, alternatively, grow into large firms themselves). However, it does not allow us to identify the firms in the actual acquisition deals and to follow their outcomes over time. Therefore, we construct ourselves a new micro database that can be used to track firms before and after acquisitions, and thus to analyse the impact of acquisitions on the involved firms. To do so, we combine information on acquisitions (from the ThomsonONE M&A database), patents (from the NBER patent data project) and accounting data (from Compustat).

We use our dataset to document some stylized facts, showing for instance that there is positive assortative matching in the startup acquisition process. Most importantly, however, we use it to study the impact of acquisitions on the implementation of ideas. To do so, we analyse the post-acquisition behavior of patent citations. We interpret an increase in the citations received by a startup patent after acquisition as evidence for the associated idea being implemented (consistent with incumbents having an implementation advantage), and a decrease as evidence for the idea being sidelined (consistent with killer acquisitions). To control for selection, we match each patent of an acquired startup to a patent of a non-acquired startup with the same application year, technology class and pre-acquisition citations. For the average industry, we find that acquisition does not affect startup patent citations, implying that positive and negative effects roughly cancel out. In some industries, however, killer acquisitions dominate (and in line with Cunningham *et al.*, 2020, this includes the pharmaceutical industry).

While this cross-sectional evidence provides some insights about the effects of acquisitions, it is obviously silent about aggregate general equilibrium effects that affect all firms simultaneously. To take these channels into account, we rely on our model. However, we use our cross-sectional findings, as well as other moments from the micro data, to calibrate the model and identify its parameter values.

To understand the link between acquisitions and growth in the calibrated model, we first consider comparative statics with respect to incumbents' startup search costs. These costs can be seen as a reduced-form indicator of frictions in the acquisition market. When

The extent of reallocation varies widely: Cunningham *et al.* (2020) show that in the pharmaceutical industry, only 22% of researchers keep working for the acquirer, but Time Magazine (article cited in Footnote 3) reports this number is three times as high at Google. Tech companies have even coined the term "acqui-hire", with Facebook's CEO Mark Zuckerberg stating that "we have not once bought a company for the company. We buy companies to get excellent people" (https://www.youtube.com/watch?v=OlBDyItD0Ak). Reallocation may change the productivity of the affected researchers (and their colleagues) through knowledge spillovers, discouragement and other effects.

they are zero, incumbents may acquire any threatening startup, if they find it optimal to do so. When they are infinite, there are no acquisitions. Our calibration suggests that high search costs (infrequent acquisitions) imply high productivity growth, while low search costs (frequent acquisitions) imply low productivity growth.

To understand this relationship, we rely on a useful decomposition. We show that any change in the growth rate from its baseline calibration value can be computed as a weighted average of the change in incumbents' own innovation and the change in innovation due to startup ideas (which, in turn, is the product of the startup rate and the percentage of startup ideas being implemented). Analysing these three sources of variation, we find that more frequent acquisitions are associated with a higher startup rate, as startups benefit from the option of selling out. However, acquisitions also slow down creative destruction, so that the average incumbent is more likely to have a high productivity advantage over its competitors, and therefore low incentives to innovate and to implement an acquired idea. Moreover, the higher startup rate erodes the value of incumbents: even though they might avoid displacement by buying startups, these acquisitions are costly. As the value of incumbents falls, their innovation incentives decrease. Therefore, as acquisitions become more frequent, both incumbent innovation and the percentage of implemented startup ideas fall. Because incumbents represent the largest share of overall innovation, we find that these effects more than compensate for the higher startup rate, dragging the growth rate down.

In line with these results, we find that a ban on all startup acquisitions would increase the aggregate growth rate by about 0.04 percentage points by year. This occurs despite a significant fall in the startup rate, as the former is compensated by an increase in incumbent innovation and an increase in the percentage of implemented startup ideas.

Finally, we explore how these findings depend on our calibration choices. We find that startup acquisitions are particularly harmful when they are frequent and when incumbents cannot develop ideas efficiently. In contrast, startup acquisitions can enhance growth in situations in which startups have a strong comparative advantage in idea generation, while incumbents have a strong comparative advantage in implementation and development. However, our calibration indicates that most US industries are not in such a beneficent "division of labor" equilibrium.

Related literature There is a growing empirical literature on the effect of acquisitions on innovation. The influential work of Cunningham *et al.* (2020) on the US pharmaceutical industry provides evidence for several of the channels discussed above. The authors show that acquirers are likely to stop drug research projects of acquired firms when these overlap with their own drug portfolio. These killer acquisitions are more likely if incumbents have a dominant market position. In earlier studies, Seru (2014) and Haucap, Rasch and Stiebale (2019) also provide evidence for a negative effect of mergers and acquisitions (M&As) on firm R&D. Phillips and Zhdanov (2013) instead argue that acquisitions stimulate innovation by small firms that want to be acquired in the future. Using data on publicly traded firms, they show that the R&D of small firms increases after an industry-level acquisition shock. Bena and Li (2014) provide evidence for positive knowledge spillovers after mergers, while Kim (2020) shows that employee mobility after acquisitions can be detrimental to the acquirer in the long run. We provide empirical evidence from a new data set that corroborates some of these findings. However, the main contribution of our paper is to use a general equilibrium model (disciplined by the empirical evidence) to assess the macroeconomic significance of these cross-sectional findings.

On the theoretical side, there has been an intense interest in the industrial organization literature on the effect of M&As on innovation (see Federico, Langus and Valletti, 2017; Cabral, 2018; Bourreau, Jullien and Lefouili, 2018; Bryan and Hovenkamp, 2020; Callander and Matouschek, 2020; Fumagalli, Motta and Tarantino, 2020; Kamepalli, Rajan and Zingales, 2020; Letina, Schmutzler and Seibel, 2020; Denicolò and Polo, 2021). These studies are based on partial equilibrium models, while we take an aggregate general equilibrium perspective.

There are also some recent studies on the macroeconomic effect of M&As. For instance, Dimopoulos and Sacchetto (2017) and David (2020) analyze the effects of M&As on the allocation of capital, but do not consider innovation and productivity growth.[7] More closely related to us, Cavenaile, Celik and Tian (2020) develop an endogenous growth model with mergers between incumbents, and analyze the effect of these mergers on innovation incentives. Our focus is different, as we study the acquisition of startups by incumbents, leading us to consider novel issues such as killer acquisitions.[8] Finally, Lentz and Mortensen (2016) and Akcigit, Celik and Greenwood (2016) incorporate different versions of a market for ideas (through buyouts or patent sales) in endogenous growth models, showing that such markets improve the allocation of ideas. More broadly, we contribute to the literature on endogenous growth and firm dynamics (Klette and Kortum, 2004; Aghion, Akcigit and

[7]There is also an extensive literature on the microeconomic effects of M&As on investment, the allocation of capital, firm productivity and competition. Important studies include Jovanovic and Rousseau (2002), Rhodes-Kropf and Robinson (2008), Blonigen and Pierce (2016), and Wollmann (2019). Some studies have also considered startup acquisitions in particular. For instance, Andersson and Xiao (2016) document a number of stylized facts on startup acquisition in Sweden.

[8]Our paper is also related to Celik, Tian and Wang (2020), who study the effects of information frictions in the merger market on firm innovation and business dynamism.

Howitt, 2014; Akcigit and Kerr, 2018; Peters, 2020), by extending its standard framework to incorporate acquisitions and study their macroeconomic impact.

The remainder of the paper is organized as follows. Section 2 describes our micro-level data, and uses it to derive some stylized facts on acquisitions, innovation and the link between these two in the United States. Section 3 presents our model, derives its solution, and discusses its main properties. Section 4 discusses the calibration, comparative statics and our counterfactual experiments. We conclude in Section 5.

2 Data and stylized facts

2.1 Startup acquisitions in the United States

How frequent are acquisitions of innovative startups in the United States? Answering this question is not straightforward, as there is a limited amount of publicly available data on startup activity. The most comprehensive data is due to Guzman and Stern (2020), who compiled a database containing all new firms incorporated in 32 states (representing around 80% of US GDP) between 1988 and 2014.[9] Their database contains information about firm characteristics at incorporation (e.g., whether the firm holds a patent application) and about growth outcomes. In particular, for all firms incorporated between 1988 and 2008, Guzman and Stern record whether, during their first six years of existence, the firms are acquired, do an initial public offering (IPO), or grow to 100 or more employees.

Table 1: Startup growth outcomes

Sample	(1) All startups	(2) Patenting startups	(3) Patent & Delaw. inc.
Total number	18,764,856	37,588	10,804
Outcome after 6 years			
... Acquisition	0.06%	4.02%	9.32%
... IPO	0.01%	1.13%	2.94%
... 100+ employees	0.23%	6.60%	13.74%

Source: Guzman and Stern (2020), own computations. The sample contains all newly incorporated firms incorporated in 32 US states between 1988 and 2008. Column (1) refers to all startups, column (2) to startups with a patent application, and column (3) to startups with a patent application and an incorporation in Delaware.

Column (1) in Table 1 shows that in the overall population of startups, acquisitions are

[9] Their data can be downloaded at https://www.startupcartography.com/.

very rare events: only 0.06% of startups are acquired within their first 6 years of existence. However, it is well known that most newly created firms do not have growth ambitions and remain small throughout their existence (Hurst and Pugsley, 2011). Thus, for our purpose, it is more relevant to consider a subsample of potentially innovative and growth-oriented startups. To do so, we focus on patenting startups (precisely, on startups that hold a patent application at the time of incorporation). As shown in column (2), acquisitions of patenting startups are much more frequent: a little over 4% of them are acquired within their first six years of existence. Patenting startups are also much more likely to achieve an IPO or significant employment growth.[10]

Figure 1 plots the percentage of acquired patenting startups by incorporation year. Acquisitions peak for the 1999-2000 startup cohorts, i.e., in the middle of the dot-com boom, at around 6%. However, there does not appear to be a decisive trend over time.[11]

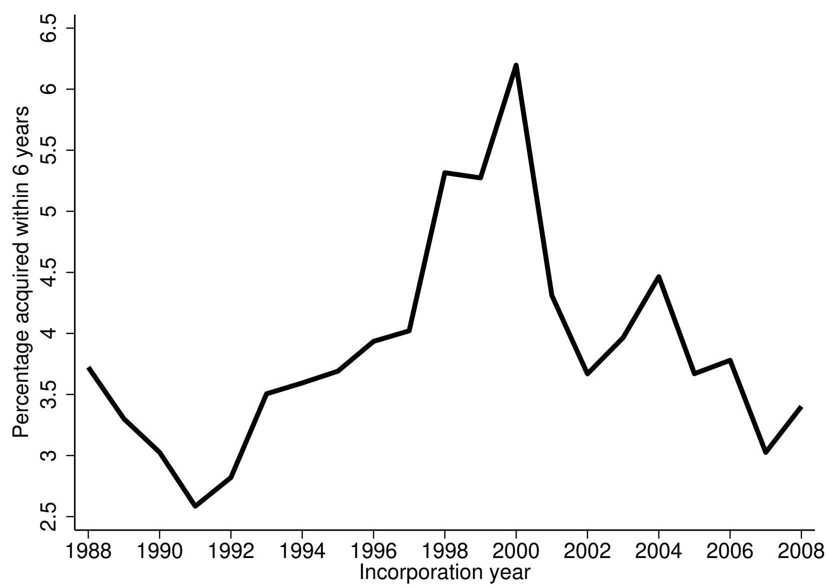

Figure 1: Acquisitions of patenting startups (data from Guzman and Stern (2020))

Overall, the evidence presented in this section suggests two insights. First, around 4% of innovative startups in the US get acquired during their first six years of existence. Second,

[10]Column (3) shows that acquisitions, IPOs and employment growth are even more prevalent among patenting firms that, apart from incorporating in their home state, also file an incorporation in Delaware (which offers tax and judicial advantages). Indeed, Guzman and Stern (2020) show that holding a patent and incorporating in Delaware is one of the strongest correlates of entrepreneurial success.

[11]In line with the literature, we do observe, however, a downward trend in the percentage of startups doing an IPO (see e.g. Ewens and Farre-Mensa, 2020), as well as in the percentage of startups experiencing strong employment growth (see e.g. Decker, Haltiwanger, Jarmin and Miranda (2016)). The fact that startup acquisitions do not increase seems to indicate that these trends are not primarily due to high-growth startups being acquired more frequently.

while there has been some cyclical fluctuation, this percentage has neither trended up or down during the period 1988-2014.

These facts provide us a good first sense of the prevalence of startup acquisitions. However, the Guzman and Stern (2020) database does not contain information about the acquiring firm, or about the startup's patenting behaviour (beyond the fact of holding a patent application in the incorporation year). Therefore, in the next section, we construct a dataset that contains information on these elements. While our data has some disadvantages with respect to Guzman and Stern (most importantly, the fact that we do not observe firm incorporation dates), it also contains important new information, allowing us to describe further characteristics of startup acquisitions and to uncover causal evidence of the effect of startup acquisitions on the involved firms.

2.2 Combining acquisition and patenting data

To construct our dataset, we merge three sources of information: data on acquisitions from the financial information provider Refinitiv (formerly Thomson Financial), patent data from the NBER Patent Data Project, and accounting data for public firms from Compustat. This section describes our data sources in greater detail.

Acquisitions data To track acquisitions, we rely on the ThomsonONE database, using information between 1981 and 2014.[12] The database provides transaction-level data on mergers and acquisitions (M&As) and includes practically all deals involving US firms over the considered time period. ThomsonONE provides several variables of interest, such as the names of the involved firms, the industries in which they operate, the announced and effective dates of the deal, the transaction value, and sometimes even the revenue and total assets of the involved firms.

Patent data In order to measure the innovation activity of firms, we rely on patent data, as provided by the NBER Patent Data Project (NBER-PDP), which provides US patent data for 1976-2006.[13]. In addition to the patent owner, this dataset also provides us with the forward and backward citations to the patent, a measure of each patent's originality and generality, and IPC technology classes.

[12]This is a commercial database, which can be accessed at `https://www.refinitiv.com/en/products/sdc-platinum-financial-securities`. Due to various changes for the providing firm, the database has frequently changed names and is currently branded as the Refinitiv SDC Platinum database. It is the standard database used in M&A analysis (see e.g. David (2020) or Guzman and Stern (2020)).

[13]The dataset can be downloaded at https://sites.google.com/site/patentdataproject/.

A challenge in matching firm-level data to patents is that firm names are inconsistently recorded on patent files, which leads to many false negative matches. There are two reasons for this: first, the lack of a unique firm identifier in the patent data; second, the lack of uniformity in how company names appear. To address this problem, the NBER-PDP standardizes commonly used words in firm names (Bessen, 2009).

Accounting data Finally, we use the Compustat North America database, provided by Standard & Poor's.[14] This database contains balance sheet and income statement information for all publicly traded firms in the United States.

Merging these three databases is straightforward for publicly listed firms, because both ThomsonONE and the NBER Patent Data Project provide firm identifiers that are consistent with Compustat. For private firms appearing in the M&A dataset, the situation is more challenging. First, for these firms, we do not have accounting data. Second, in order to match them to their patents, we can only rely on their names. Precisely, we standardize the company name provided by ThomsonONE, and then employ a fuzzy name matching algorithm and a large scale manual check to match each company to its patents recorded in the NBER PDP database.

2.3 Definitions and descriptive statistics

Startups: definition and importance In line with our focus on innovative firms, we will consider throughout acquisitions in which the acquired firm holds at least one patent. Our dataset does not allow us to observe the exact incorporation date of a firm, but it does provide us with its complete patent history. Therefore, we define a firm as a startup if it is within 6 years of its first patent. Using this definition, we find that around 47% of all acquisitions of private firms in our sample are acquisitions of patenting startups. Thus, innovative startup targets account for a sizeable share of overall acquisition activity.

Startups are also important drivers of the overall innovation effort. Startups (i.e., firms within 6 years of their first patent) account for 25% of all patent applications. Remarkably, however, their patents collect 65% of all patent citations. This suggests that startup patents are on average of higher quality than patents filed by older firms (in line, for instance, with the findings of Akcigit and Kerr, 2018). Thus, their innovation behavior (and the way in

[14]The database can be accessed at `https://www.spglobal.com/marketintelligence/en/?product=compustat-research-insight`.

which it is affected by acquisitions) is likely to have a disproportionate impact on aggregate outcomes.

Selection into acquisition The acquisition process is obviously not random: both the acquiring firms and the startups that they acquire are a selected sample of the overall population of firms. For instance, Figure 2 compares the sales of acquiring to non-acquiring public firms in our sample. Through our sample period, acquirers are systematically larger than non-acquirers, by a factor of about 3.

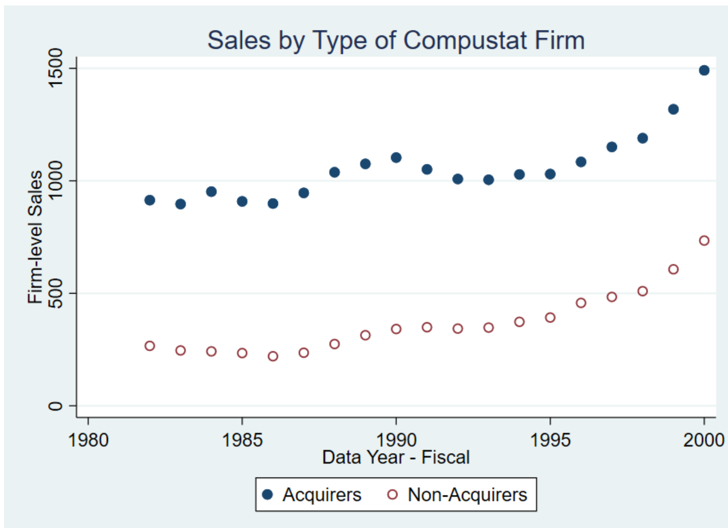

Figure 2: Sales by type of firm: acquirers vs. non-acquirers. Data from ThomsonONE, NBER Patent Data project and Compustat.

Likewise, acquired startups are different from non-acquired startups. For instance, we find that around 1.6% of patenting startups in our sample are eventually acquired. However, these startups represent 6% of all startup patent citations, suggesting that their patents are of above-average quality. In sum, there appears to be positive assortative matching in the acquisition process, as the largest incumbents match with the “best” startups. Our model will reproduce some of these selection effects.

These stylized facts provide some further information on the importance and characteristics of startup acquisitions. However, our data also allows us to dig deeper into the effects of these acquisitions on innovation. We do so in the next section.

2.4 The effect of acquisitions on the implementation of ideas

Our important channel through which acquisitions can affect innovation is their effect on the implementation probability of startup ideas. An acquisition may increase this probability (if incumbents have advantages in developing ideas and bringing them to the market) or decrease it (if incumbents are engaging in killer acquisitions). In this section, we try to assess the relative strength of these forces.

To do so, we need a proxy for the implementation of startup ideas. We propose to rely on the evolution of patent citations after the acquisition event. That is, we consider the set of patents that the startup held before the acquisition. If citations to these pre-existing patents increase after the acquisition, we interpret this as evidence for the startup's ideas being further developed and built upon. If, on the other hand, citations to these patents decrease after the acquisition, we interpret this as evidence for the idea being shelved.[15]

Of course, just considering the change in patent citations after acquisition faces an endogeneity problem: in the previous section, we have shown that acquired patents are different from the average patent. Therefore, we use a matching method (nearest neighbor matching), to link each *treated* patent (i.e., belonging to a startup that will eventually be acquired) to a *control* patent (belonging to a non-acquired startup). We match on several patent and firm characteristics including technological subsector, citations received before acquisition, or patent application year. We artificially assign to each control patent the acquisition year of its matched treated patent.

The regression specification looks as follows:

$$\begin{aligned} NumCites_{it} = \beta_0 + \beta_1 \cdot D(Treatment)_i + \beta_2 \cdot D(Post)_{it} \\ + \beta_3 \cdot D(Treatment)_i \cdot D(Post)_{it} + u_{it}, \end{aligned}$$

where $NumCites_{it}$ are the number of citations received per patent-year, $D(Treatment)_i$ takes value 1 for treated patents, and $D(Post)_{it}$ takes value 1 for the years after acquisition. If $\beta_3 > 0$, then a patent receives more citations (our proxy for the implementation of ideas) after being acquired. Instead, if $\beta_3 < 0$, a patent receives relatively more citations if it is not acquired.

Table 2 presents the estimation results. When a patent changes ownership from a startup to the acquiring firm, its number of citations received (compared to the change experienced by the control patent) stays roughly the same in the full sample (columns (1) and (3)). Thus, it seems that potential development advantages and killer acquisition motives of incumbents roughly cancel out for the average acquisition.

This average finding potentially hides substantial heterogeneity. Indeed, columns (2) and (4) of Table 2 show that results change substantially when we restrict the sample to

[15] In line with this interpretation of patent citations, Argente, Baslandze, Hanley and Moreira (2020) show that in the consumer goods sector, more highly cited patents lead to a higher likelihood of introducing new products.

Table 2: Effects of Acquisitions on the Implementation of Ideas

Dep.Var.: Number of Cites	(1)	(2)	(3)	(4)
D(Post)	0.623***	0.496	0.738***	0.503*
	(0.101)	(0.313)	(0.096)	(0.301)
D(Treatment)			0.398***	0.669***
			(0.132)	(0.175)
D(Post)*D(Treatment)	0.145	-0.401**	0.034	-0.337*
	(0.187)	(0.179)	(0.175)	(0.184)
Observations	13,518	1,410	13,536	1,410
Sample	Full	Pharma	Full	Pharma
Year FE	✓	✓	✓	✓
Patent FE	✓	✓		
Matched Pair FE			✓	✓

Notes: A Poisson estimator is used. The dependent variable is the number of citations received at the patent-year level. $D(Treatment)_i$ takes value 1 for treated patents, and $D(Post)_{it}$ takes value 1 for the years after acquisition. significant at 10%; ** significant at 5%; *** significant at 1%.

the pharmaceutical industry: now, acquisitions are associated with a 33% drop in citations to the startups' pre-existing patents. This finding is consistent with the evidence provided by Cunningham *et al.* (2020) for this industry.

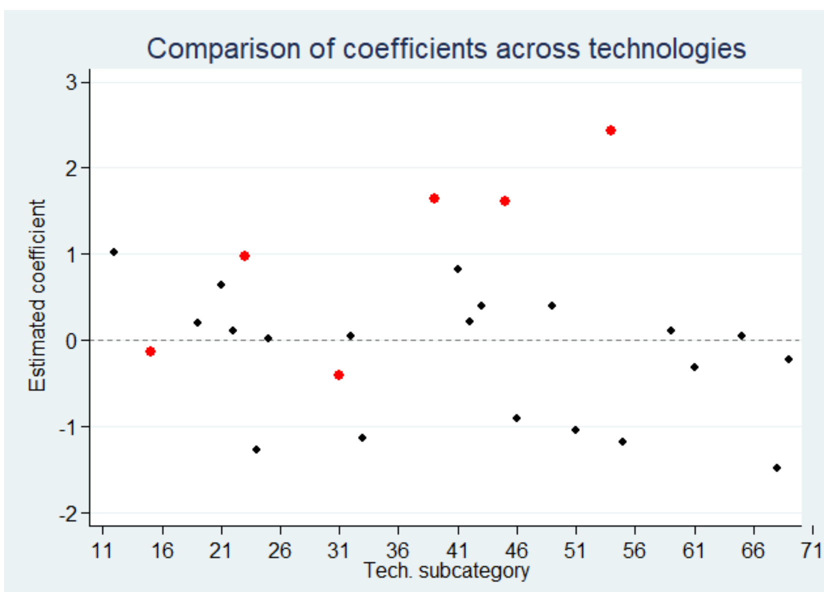

Figure 3: Estimated coefficients of the matching estimation for each technological subcategory

Graphically, Figure 3 displays the estimated coefficient of the interaction term for each technological subcategory. The small blue dots represent non-statistically significant coefficients, while the larger red dots display the ones that are statistically different from zero. The pharmaceutical industry (subcategory 31) is one of the six subcategories with an estimated coefficient that is statistically different from zero. For all the remaining subcategories, we cannot reject a zero value.

Summing up, our findings in this section indicate that the average acquisition does not seem to affect the likelihood that startup ideas are implemented. Therefore, acquisitions appear unlikely to substantially affect innovation and growth through this channel. However, the implementation channel is not the only potential link between acquisitions and innovation: acquisitions also affect the innovation behavior of incumbents, as well as the incentives to create a startup in the first place. Moreover, many of these effects are general equilibrium effects that affect all firms and can thus not be identified with a cross-sectional analysis. To fully study these links, we now introduce our model. However, we will return to the stylized facts and the regression evidence when calibrating the model.

3 Model

In this section, we develop a model of the macroeconomic linkages between startup acquisitions and innovation. While we build on Schumpeterian heterogeneous-firm growth models, our model introduces two important new elements: a distinction between the invention and the implementation of ideas, and the possibility of startup acquisitions.

3.1 Assumptions

Preferences and technology Time is continuous, runs forever and is indexed by $t \in \mathbb{R}_+$. A representative consumer maximizes lifetime utility, given by

$$U = \int_0^{+\infty} e^{-\rho t} \ln \left(C_t \right) \mathrm{d}t, \tag{1}$$

where $\rho > 0$ is the time discount rate and C_t stands for the consumption of the unique final good at instant t. We normalize the price of the final good to one. The household is endowed with L units of time, which she supplies inelastically at the market-clearing wage w_t. Furthermore, the household owns all firms in the economy and accumulates wealth $\mathcal{A}_t$ according to the budget constraint $\dot{\mathcal{A}}_t = r_t \mathcal{A}_t + w_t L - C_t$, where r_t is the rate of return on assets.

The final good is produced under perfect competition and assembled from a continuum of differentiated products with a CES production function. Thus, final output is

$$Y_t = \left(\int_0^1 \left(\omega_{jt}\right)^{\frac{1}{\varepsilon}} \left(y_{jt}\right)^{\frac{\varepsilon-1}{\varepsilon}} \mathrm{d}j \right)^{\frac{\varepsilon}{\varepsilon-1}}, \tag{2}$$

where y_{jt} is the output of product j at instant t, ω_{jt} is the quality of product j at instant t, and $\varepsilon > 1$ is the elasticity of substitution between products. Product quality follows an exogenous stochastic process. We assume that quality can take values in a finite set Ω, and that firms transition from state ω to state ω' at a Poisson rate $\tau_{\omega,\omega'}$. We also assume that the economy starts in the steady state of this process, and for convenience we normalize $\int_0^1 \omega_{jt} \mathrm{d}j = 1$.

Each product can potentially be produced by a large number of firms f, with a linear production technology using labor:

$$y_{jft} = a_{jft} l_{jft}, \tag{3}$$

where y_{jft} is the output of product j by firm f at instant t, a_{jft} is the productivity of the firm, and l_{jft} is the labor input. We assume that there is static Bertrand competition on product markets. As we show later, this implies that each product is only produced by the highest-productivity firm in equilibrium. We denote the productivity of this firm by a_{jt}, and define average productivity A_t as

$$A_t \equiv \left(\int_0^1 a_{jt}^{\varepsilon-1} dj \right)^{\frac{1}{\varepsilon-1}}. \tag{4}$$

Productivity is improved through innovations, which are the result of a two-step process. First, firms invest into research in order to generate new ideas. Then, they invest into development in order to implement these ideas and turn them into innovations. The next sections describe these research and development (R&D) technologies.

Research and Development Innovations are generated by incumbent firms (i.e., firms which already produce at instant t) and by a large mass of potential entrants, which we refer to as startups.

To generate an idea at a Poisson arrival rate z, an incumbent must pay a research cost of $\xi_I \cdot z^{\psi} \cdot \widetilde{a}_{jt}^{\varepsilon-1} \cdot Y_t$ units of the final good. In this cost function, $\xi_I > 0$ is a cost shifter, $\widetilde{a}_{jt} \equiv \frac{a_{jt}}{A_t}$ is the relative productivity of the incumbent firm, and $\psi > 1$ is the elasticity of research output with respect to research spending. Thus, research costs are increasing and convex in the arrival rate of ideas. Furthermore, they are proportional to the relative productivity of the incumbent and to aggregate GDP. These scaling assumptions are necessary to ensure balanced growth.[16]

To implement an idea, the incumbent needs to invest into development. Precisely, if the incumbent invests $\kappa_I \cdot i_I^{\psi} \cdot \widetilde{a}_{jt}^{\varepsilon-1} \cdot Y_t$ units of the final good (with $\kappa_I > 0$), it successfully implements the idea with probability i_I.[17] As usual in endogenous growth models, we assume that productivity evolves on a ladder, with step size $\lambda > 1$. An implemented idea (an innovation) increases the productivity of the incumbent by one step on this ladder, i.e., by a factor λ. Instead, an idea that is not implemented disappears forever. Therefore, ideas are either implemented immediately or never.

Ideas and innovations are also generated by startups. We assume that a startup can be created at a fixed cost $\xi_S \cdot Y_t$, and generates a Poisson arrival rate 1 of ideas. A startup's idea applies to a randomly drawn good $j \in [0, 1]$. As for incumbents, startup ideas are either implemented immediately or never. Precisely, when the startup invests $\kappa_S \cdot i_S^{\psi} \cdot \widetilde{a}_{jt}^{\varepsilon-1} \cdot Y_t$ units of the final good (with $\kappa_S > 0$), it implements the idea with probability i_S. To reflect the empirical fact that startup ideas might represent larger advances than incumbent ideas (see Section 2.3), we assume that a startup idea increases productivity by $n_S = 1 + N$ steps (of size λ each), where $N \in \mathbb{N}$ is drawn from a Poisson distribution with parameter γ. Thus, on average, a startup idea represents γ more steps on the productivity ladder than an incumbent idea. Importantly, we assume that the quality of the idea is only revealed after investing into development.

In equilibrium, a startup that implements its idea displaces the incumbent producer of product j and becomes the new incumbent in this product line. However, the startup may not always choose to implement: alternatively, it can be acquired by the incumbent. In the next section, we describe these acquisitions.

Acquisitions We assume that acquisitions can take place if, and only if, there is a "meeting" between the startup and the threatened incumbent producer.

The meeting probability is endogenous, and depends on the effort of the incumbent in monitoring the startup scene. We assume an incumbent needs to spend $\chi \cdot s^{\varphi} \cdot \widetilde{a}_{jt}^{\varepsilon-1} \cdot Y_t$ (with $\chi > 0$ and $\varphi > 1$) units of the final good in order to generate a probability s to meet a startup that innovates on its product. Thus, the search costs for startups are increasing

[16] In particular, the fact that costs scale with relative productivity makes research choices independent of current productivity, as in Peters (2020). Without this assumption, more productive incumbents innovate more, and production is eventually taken over by an arbitarily small number of firms.

[17] In fact, we assume that the implementation probability is given by $\min(i_I, 1)$, so that it is always well defined. However, we choose parameter values ensuring that firms never choose an implementation probability of 1. For simplicity, we therefore omit the min operator in the text. The same statement applies to all other implementation and meeting probabilities introduced below.

and convex in the search effort. As usual, they also scale with relative productivity and aggregate GDP to ensure balanced growth. We think of this framework as a reduced-form model of information and search frictions in the acquisition market. These frictions prevent incumbents from noticing all threatening startups and force them to spend resources in order to monitor the market.

When there is a meeting, the incumbent may acquire the startup. The incumbent then transfers p_{jt}^{A} units of the final good (the acquisition price) to the startup, in exchange for the startup exiting forever and handing over its idea to the incumbent. The incumbent then invests into the development of the startup's idea, using its own development technology. That is, by investing $\kappa_I \cdot i_A^{\psi} \cdot \widetilde{a}_{jt}^{\varepsilon-1} \cdot Y_t$ units of the final good, it implements the idea with probability i_A.

Acquisitions occur if, and only if, they generate a surplus, that is, if and only if the joint value of both firms after the acquisition is larger than the sum of their outside options. The acquisition price is determined through Nash bargaining over the surplus, where the incumbent has a bargaining weight $\alpha \in (0, 1)$. There are two reasons for which acquisitions may generate a surplus in the model. First, the startup's idea may be more valuable in the hands of the incumbent (e.g., because the latter has lower development costs). Second, acquisitions prevent entry, and therefore prevent the destruction of incumbent rents. While the first force corresponds to a socially valuable transfer of ideas, the second does not. As we will see later, the relative strength of these forces plays an important role for the aggregate implications of startup acquisitions.

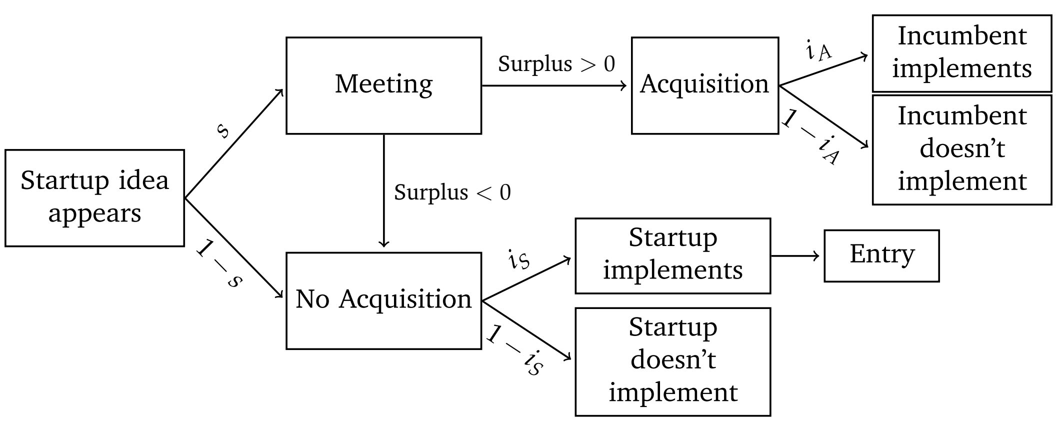

Figure 4: Timing of events for a startup idea within a period $(t, t + dt)$.

Timing Figure 4 summarizes the timing of events for a startup idea within an instant of length $(t, t + dt)$. After the idea appears, the incumbent might or might not notice it, depending on the search probability s. If there is no meeting, the startup decides whether or not to implement it (with probability i_S), which leads to possible entry and displacement of the incumbent. If there is a meeting, then there is an acquisition if, and only if, the acquisition surplus is positive. In case of an acquisition, the incumbent then chooses the probability i_A with which to implement the startup's idea.

3.2 Equilibrium

Throughout, we consider a balanced growth path (BGP) equilibrium with positive entry, in which all aggregate variables grow at a constant rate g.

3.2.1 Household decisions, prices and profits

On the BGP, the representative consumer's optimal consumption choice satisfies the Euler equation

$$\frac{\dot{C}_t}{C_t} \equiv g = r - \rho. \tag{5}$$

Bertrand competition implies that each product is only produced by the highest-productivity firm. However, pricing decisions depend on the relative productivity of this firm with respect to its closest follower (the firm with the second-highest productivity). As productivity evolves on a ladder, we can define the "technology gap" (the number of productivity steps between the incumbent and the follower), as the integer n_{jt} holding

$$\lambda^{n_{jt}} \equiv \frac{a_{jt}}{a_{jt}^F}, \tag{6}$$

where a_{jt}^F is the productivity of the follower. Note that in our model, the follower is an old incumbent: once a startup displaces an incumbent, the latter becomes the new follower.

The demand for each product j is given by the isoelastic function $y_{jt} = \omega_{jt} \cdot \left(p_{jt}\right)^{-\varepsilon} \cdot Y_t$. Thus, if incumbents could freely choose their price, they would set a constant markup over their marginal cost. However, their price must also be low enough to keep the follower out of the market. For any product j, the average cost of the follower at instant t is by a factor $\lambda^{n_{jt}}$ higher than the one of the incumbent. Thus, when the incumbent charges a markup $\lambda^{n_{jt}}$, the follower makes zero profits and does not produce. Accordingly, markups are

$$\mu(n_{jt}) = \min\left(\lambda^{n_{jt}}, \frac{\varepsilon}{\varepsilon - 1}\right). \tag{7}$$

For high technology gaps, the incumbent can charge the monopoly markup, while for low technology gaps, it must charge a lower markup to keep the follower out.

This markup choice implies that the price of any product j is given by $p_{jt} = \mu(n_{jt}) \cdot \frac{w_t}{a_{jt}}$, and profits are

$$\pi_t\left(\omega_{jt}, n_{jt}, a_{jt}\right) = \omega_{jt} \cdot \left(1 - \frac{1}{\mu\left(n_{jt}\right)}\right) \cdot \left(\mu\left(n_{jt}\right)\right)^{1-\varepsilon} \cdot \left(\frac{a_{jt}}{w_t}\right)^{\varepsilon-1} \cdot Y_t \tag{8}$$

Equation (8) shows that profits are increasing in product quality ω_{jt}, in productivity a_{jt} and in the technology gap n_{jt}. In particular, note that profits are concave in n_{jt}. Indeed, higher technology gaps imply higher markups, but as the firm approaches the unconstrained monopoly markup, these gains become smaller and eventually vanish.

3.2.2 Research, Development and Acquisitions

Incumbent's dynamic decisions At every point in time, incumbents need to choose an optimal level of research spending z and search effort s. Moreover, whenever they obtain an idea, they need to choose an optimal level of development spending, and whenever they meet a startup, they must decide whether to acquire it.

The dynamic problem of the incumbent has two endogenous state variables (the technology gap n and productivity a) and one exogenous state variable (product quality ω). Furthermore, the value function also depends on some aggregate variables, which change over time. Thus, we denote the value function by $V_t(\omega, n, a)$. On the BGP, the Hamilton-Jacobi-Bellman (HJB) equation is

$$\begin{aligned} r \cdot V_t(\omega, n, a) = \max_{z,s} \Bigg\{ & \underbrace{\pi_t\left(\omega, n, a\right)}_{\text{Profits}} - \underbrace{\xi_I \cdot z^{\psi} \cdot \widetilde{a}_t^{\varepsilon-1} \cdot Y_t}_{\text{Research cost}} - \underbrace{\chi \cdot s^{\varphi} \cdot \widetilde{a}_t^{\varepsilon-1} \cdot Y_t}_{\text{Search effort}} \\ & + \underbrace{z \cdot \max_{i_I} \left[i_I \cdot \Big(V_t(\omega, n+1, \lambda a) - V_t(\omega, n, a) \Big) - \kappa_I \cdot i_I^{\psi} \cdot \widetilde{a}_t^{\varepsilon-1} \cdot Y_t \right]}_{\text{Own innovation}} \\ & + \underbrace{x \cdot \left[s \cdot V_t^{\text{Meet}}(\omega, n, a) + (1-s) \cdot V_t^{\text{NoMeet}}(\omega, n, a) - V_t(\omega, n, a) \right] \Bigg\}}_{\text{Startup appears}} \\ & + \underbrace{\sum_{\omega' \in \Omega} \tau_{\omega,\omega'} \cdot \Big[V_t(\omega', n, a) - V_t(\omega, n, a) \Big]}_{\text{Quality shock}} + \underbrace{\dot{V}_t(\omega, n, a)}_{\text{Drift}}. \end{aligned} \tag{9}$$

The HJB equation shows how the discounted value of the firm changes over time. First, at every instant, the firm collects static profits and spends on research and startup search, as shown in the first line. As shown in the second line, the incumbent discovers an idea at Poisson rate z, and then chooses the optimal development investment i_I. An implemented idea increases its technology gap by one step and its productivity by a factor of λ. The third line shows that at rate x, a startup makes an innovation on the incumbent's product. In that case, there is a meeting (and thus potentially an acquisition) with probability s, and no meeting with probability $1-s$. We denote by $V_t^{\text{Meet}}(\omega, n, a)$ the expected continuation value of the incumbent in case there is a meeting, and by $V_t^{\text{NoMeet}}(\omega, n, a)$ the expected continuation value of the incumbent in case there is no meeting. Finally, the fourth line shows that the incumbent is subject to exogenous product quality shocks, and that its value drifts over time due to aggregate growth.

Acquisitions and Startup creation To analyze the interaction between an incumbent and a startup that threatens to replace it, we first consider the case in which there is no meeting between both firms. In that case, there is no acquisition, and the incumbent's expected continuation value is

$$V_t^{\text{NoMeet}}(\omega, n, a) = \Big[1 - i_{S,t}\,(\omega, a)\Big] \cdot V_t(\omega, n, a), \tag{10}$$

where $i_{S,t}\,(\omega, a)$ is the startup's optimal development probability. When the startup does not implement its idea, the incumbent's continuation value is just its current value. Instead, when the startup implements its idea, the incumbent is displaced and its continuation value is zero.

Likewise, we can derive the expected value of a startup in the absence of a meeting, denoted by $V_{S,t}^{\text{NoMeet}}\,(\omega, a)$. This quantity holds

$$V_{S,t}^{\text{NoMeet}}\,(\omega, a) = \max_{i_S} \left\{ i_S \cdot \left(\sum_{n_S=1}^{+\infty} \theta(n_S) \cdot V_t(\omega, n_S, \lambda^{n_S} a) \right) - \kappa_S \cdot i_S^{\psi} \cdot \widetilde{a}_t^{\varepsilon-1} \cdot Y_t \right\} \tag{11}$$

where $\theta(n_S) \equiv e^{-\gamma} \cdot \frac{\gamma^{n_S-1}}{(n_S-1)!}$ denotes the probability that the startup's innovation advances productivity by $n_S = 1, 2, \ldots$ steps. In the absence of a meeting, a startup chooses an optimal level of development investment i_S. When its idea is implemented, the startup becomes the new incumbent producer. With probability $\theta(n_S)$, it takes n_S steps on the productivity ladder. It then has a technology gap of n_S (over the previous incumbent, which is now the follower) and productivity $\lambda^{n_S} a$. On the other hand, if the idea fails, the startup exits forever and has a continuation value of zero.

Next, we turn to the case in which a meeting does take place. To determine whether this leads to an acquisition, we compute the surplus that would be generated by an acquisition, denoted $\Sigma_t\,(\omega, n, a)$. The surplus holds

$$\begin{aligned}\Sigma_t(\omega,n,a) = \max_{i_A}\Bigg\{&(1-i_A)\cdot V_t(\omega,n,a) + i_A \cdot \sum_{n_S=1}^{+\infty} \theta(n_S)\cdot V_t(\omega, n+n_S, \lambda^{n_S} a) \\ &- \kappa_I \cdot i_A^{\psi} \cdot \widetilde{a}_t^{\varepsilon-1}\cdot Y_t\Bigg\} - V_t^{\text{NoMeet}}(\omega,n,a) - V_{S,t}^{\text{NoMeet}}\,(\omega,a)\,.\end{aligned} \tag{12}$$

In equation (12), the term inside the curly brackets captures the joint value of incumbent and startup after an acquisition. The acquisition allows the incumbent to keep its baseline value $V_t(\omega, n, a)$. Moreover, the incumbent acquires the startup's idea and chooses an optimal development investment i_A in order to implement it. In case of success, the quality of the idea is revealed, and an idea of quality n_S improves the incumbent's technology gap by n_S units and its productivity by a factor λ^{n_S}. Finally, the incumbent transfers the acquisition price to the startup (and this acquisition price is the startup's post-acquisition value). As this is a pure transfer, it does not feature in the joint value shown above. To obtain the surplus, we subtract from the joint value the outside options of incumbent and startup, which are equal to their expected values in the absence of a meeting.

An acquisition takes place if, and only if, the expected surplus is positive. Then, the surplus is split between both firms according to their Nash bargaining weights. Accordingly, the continuation value for an incumbent in case of a meeting with the startup is:

$$V_t^{\text{Meet}}(\omega,n,a) = V_t^{\text{NoMeet}}(\omega,n,a) + \alpha\cdot\max\Big(0, \Sigma_t(\omega,n,a)\Big). \tag{13}$$

For the startup, the continuation value conditional on meeting the incumbent is

$$V_{S,t}^{\text{Meet}}(\omega,n,a) = V_{S,t}^{\text{NoMeet}}\,(\omega,a) + (1-\alpha)\cdot\max\Big(0, \Sigma_t(\omega,n,a)\Big). \tag{14}$$

Whenever an acquisition takes place, this continuation value is also equal to the acquisition price. Finally, in an equilibrium with positive startup creation ($x > 0$), the following free-entry condition must hold:

$$\xi_S \cdot Y_t = \mathbb{E}_t\left[s_t(\omega,n,a)\cdot V_{S,t}^{\text{Meet}}\,(\omega,n,a) + \Big(1 - s_t(\omega,n,a)\Big)\cdot V_{S,t}^{\text{NoMeet}}\,(\omega,a)\right]. \tag{15}$$

where $s_t(\omega, n, a)$ denotes the optimal search effort by the incumbent. This equation shows that the cost of creating a startup, $\xi_S \cdot Y_t$, must be equal to the expected benefit of creating a startup, shown on the right-hand side. The startup's idea falls on a randomly chosen product j, characterized by a quality ω, a technology gap n and productivity a. The expectation operator refers to the joint distribution of products over these states. Depending on whether the startup meets an incumbent or not, it then obtains one the continuation values defined in equations (11) and (14).

Optimal policies To solve for the BGP policies, we guess and verify that the incumbent's value function holds $V_t(\omega,n,a) = v(\omega,n)\cdot\widetilde{a}_t^{\varepsilon-1}\cdot Y_t$, i.e., that the value function scales (with a time-invariant factor of proportionality) in relative productivity and aggregate GDP. Furthermore, we conjecture that aggregate productivity A_t grows at the same rate as aggregate consumption C_t and wages w_t. These guesses allow us to simplify the dynamic problem considerably. First, combining them with the Euler equation (5) and the continuation values defined in equations (10) and (13), we can rewrite the HJB equation as

$$
\begin{aligned}
\Big(\rho + (\varepsilon-1)\,g\Big)\cdot v(\omega,n) = \max_{z,s} \Bigg\{ & \omega\cdot\left(1-\frac{1}{\mu\,(n)}\right)\cdot(\mu\,(n))^{1-\varepsilon}\cdot\left(\frac{A_t}{w_t}\right)^{\varepsilon-1} - \xi_I\cdot z^{\psi} - \chi\cdot s^{\varphi} \\
& + z\cdot\max_{i_I}\left[i_I\cdot\Big(\lambda^{\varepsilon-1}\cdot v(\omega,n+1) - v(\omega,n)\Big) - \kappa_I\cdot i_I^{\psi}\right] \\
& + x\cdot\Big[s\cdot\alpha\cdot\widetilde{\sigma}(\omega,n) - i_S(\omega)\cdot v(\omega,n)\Big]\Bigg\} \\
& + \sum_{\omega'}\tau_{\omega,\omega'}\cdot\Big[v(\omega',n) - v(\omega,n)\Big]
\end{aligned}
\tag{16}
$$

where $\widetilde{\sigma}(\omega,n) \equiv \frac{\max(0,\Sigma_t(\omega,n,a))}{\widetilde{a}_t^{\varepsilon-1}\cdot Y_t}$, the normalized acquisition surplus, is time-invariant as shown in Appendix A.1. This equation pins down the value function v as a function of three endogenous aggregate constants: aggregate growth g, the startup rate x and the productivity-to-wage ratio $\frac{A_t}{w_t}$.[18]

The HJB equation implies that the incumbent's optimal research investment is

$$
z(\omega,n) = \left[\frac{i_I(\omega,n)\cdot\Big(\lambda^{\varepsilon-1}\cdot v(\omega,n+1) - v(\omega,n)\Big) - \kappa_I\cdot\big(i_I(\omega,n)\big)^{\psi}}{\xi_I\psi}\right]^{\frac{1}{\psi-1}}
\tag{17}
$$

where $i_I\,(\omega,n)$ is the optimal development probability chosen by the incumbent for its own ideas. As usual, the firm equalizes the marginal cost of research to its marginal benefit,

[18] As each startup has a Poisson arrival rate 1 of ideas, x corresponds both to the mass of startups and the arrival rate of startup ideas. As there is a mass 1 of incumbents, x is also the startup rate. Note that because average productivity and wages grow at the same rate, A_t/w_t is a constant.

which is the arrival of an undeveloped idea.

In turn, the optimal startup search investment is given by

$$s\left(\omega,n\right)=\left(\frac{x\cdot\alpha\cdot\widetilde{\sigma}(\omega,n)}{\chi\varphi}\right)^{\frac{1}{\varphi-1}}. \tag{18}$$

Intuitively, the search effort is increasing in the arrival rate of startup ideas x, in the acquisition surplus $\widetilde{\sigma}\left(\omega,n\right)$ and in the incumbent's surplus share α.

Regarding development, the investment of incumbents into their own ideas holds

$$i_I\left(\omega,n\right)=\left(\frac{\lambda^{\varepsilon-1}\cdot v(\omega,n+1)-v(\omega,n)}{\kappa_I\psi}\right)^{\frac{1}{\psi-1}}. \tag{19}$$

Again, firms equalize the marginal cost of development to its marginal benefit, which comes from improving productivity and widening the technology gap.

Investment of incumbents into acquired ideas holds

$$i_A\left(\omega,n\right)=\left(\frac{\sum_{n_S=1}^{+\infty}\theta(n_S)\cdot\lambda^{n_S\cdot(\varepsilon-1)}\cdot v(\omega,n+n_S)-v(\omega,n)}{\kappa_I\psi}\right)^{\frac{1}{\psi-1}} \tag{20}$$

Finally, the optimal development probability chosen by startups, defined in equation (11), is given by

$$i_S\left(\omega\right)=\left(\frac{\sum_{n_S=1}^{+\infty}\theta(n_S)\cdot\lambda^{n_S\cdot(\varepsilon-1)}\cdot v(\omega,n_S)}{\kappa_S\psi}\right)^{\frac{1}{\psi-1}} \tag{21}$$

Comparing equation (20) with equation (21) shows that incumbents and startups may make different development choices for the same idea. These differences stem from three sources. First, development costs may be different, and all else equal, a lower marginal cost (a lower cost shifter κ) implies higher investment. Second, incumbents can apply their innovation to their existing high technology gap (and as the profit function (8) shows, productivity and markup are complements). Third, as the value function is concave in the technology gap n, there is an Arrow replacement effect: the fact that the incumbent already earns some monopoly rents makes it less attractive to implement. When this last effect dominates, some ideas that would have been implemented by a startup will be shelved by the incumbent (i.e., some acquisitions will be killer acquisitions).

Finally, as shown in greater detail in Appendix A.1, our guesses imply that the quality, productivity and technology gap of a product at at a given point in time are independent random variables. Therefore, we have

$$m_t(\omega, n, a) = m(\omega) \cdot m(n) \cdot m_t(a), \tag{22}$$

where $m(\bullet)$ stands for the mass of products with a certain characteristic. Using this property, the free entry condition simplifies to

$$\xi_S = \sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} m(\omega) \cdot m(n) \cdot \left[v_S^{\text{NoMeet}}(\omega) + s(\omega, n) \cdot (1 - \alpha) \cdot \widetilde{\sigma}(\omega, n) \right]. \tag{23}$$

This shows that research, development and acquisition decisions are independent of productivity a. Therefore, we do not need to keep track of the productivity distribution. The invariant distribution of quality ω is exogenous. Finally, the invariant distribution of technology gaps n depends on innovation and acquisition decisions, and is derived in Appendix A.2.

In equilibrium, the startup rate x will be such that the expected value of startup creation equals the fixed cost ξ_S. However, as the previous equations show, firms' innovation and acquisition decisions also depend on two other aggregate variables, the productivity-to-wage ratio $\frac{A_t}{w_t}$ and aggregate growth g. To close the model, we derive these variables in the next section.

3.2.3 Closing the model

First, using the definition of the CES price index, in Appendix A.3 we show that the productivity-to-wage ratio holds

$$\frac{A_t}{w_t} = \left(\sum_{n=1}^{+\infty} m(n) \cdot \big(\mu(n)\big)^{1-\varepsilon} \right)^{\frac{1}{1-\varepsilon}}. \tag{24}$$

This shows that, along the BGP, aggregate productivity A_t grows at the same rate as the wage w_t. The ratio of both variables depends on the markup distribution across incumbents.

Next, we need to impose labor market clearing. Labor is in fixed supply $L > 0$ and is used only in production. Imposing labor market clearing gives an expression for the aggregate labor share (see details in Appendix A.3):

$$\frac{w_t L}{Y_t} = \left(\frac{A_t}{w_t} \right)^{\varepsilon - 1} \sum_{n=1}^{+\infty} m(n) \cdot \big(\mu(n)\big)^{-\varepsilon}. \tag{25}$$

Product market clearing, in turn, implies that aggregate output is fully used for consumption (C_t), research (R_t), development (D_t) and search (S_t). Therefore, we have

$$Y_t = C_t + R_t + D_t + S_t \tag{26}$$

where

$$R_t = Y_t \cdot \left(\sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} m(\omega) \cdot m(n) \cdot \xi_I \cdot \left(z(\omega, n)\right)^{\psi} + x \cdot \xi_S \right) \tag{27}$$

$$D_t = Y_t \cdot \left(\sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} m(\omega) \cdot m(n) \cdot \left[z(\omega, n) \cdot \kappa_I \cdot \left(i_I(\omega, n)\right)^{\psi} \right.\right. \tag{28}$$

$$\left.\left. + x \cdot \left(\widetilde{s}(\omega, n) \cdot \kappa_I \cdot \left(i_A(\omega, n)\right)^{\psi} + (1 - \widetilde{s}(\omega, n)) \cdot \kappa_S \cdot \left(i_S(\omega)\right)^{\psi} \right) \right] \right),$$

$$S_t = Y_t \cdot \sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} m(\omega) \cdot m(n) \cdot \chi \cdot \left(s(\omega, n)\right)^{\varphi}, \tag{29}$$

where $\widetilde{s}(\omega, n) \equiv s(\omega, n) \cdot \mathbb{1}_{\widetilde{\sigma}(\omega,n)>0}$ is the probability that, conditional on an arrival of a startup idea on a product of type (ω, n), an acquisition occurs. This shows that consumption grows at the same rate as output.

Finally, as shown in Appendix A.4, the growth rate is

$$g = \frac{1}{\varepsilon - 1} \cdot \left[\sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} m(\omega) \cdot m(n) \cdot b(\omega, n) \right], \tag{30}$$

where $b(\omega, n) \equiv b_I(\omega, n) \cdot \left(\lambda^{\varepsilon-1} - 1\right) + b_S(\omega, n) \cdot \left(\lambda^{\varepsilon-1} \cdot e^{\gamma \cdot \left(\lambda^{\varepsilon-1} - 1\right)} - 1\right)$ is the overall arrival rate of innovations (on average across innovation steps), and

$$b_I(\omega, n) \equiv z(\omega, n) \cdot i_I(\omega, n)$$
$$b_S(\omega, n) \equiv x \cdot \left(\widetilde{s}(\omega, n) \cdot i_A(\omega, n) + \left(1 - \widetilde{s}(\omega, n)\right) \cdot i_S(\omega) \right)$$

are the arrival rates of innovations generated by incumbents (b_I) and startups (b_S), respectively. The formula illustrates that when γ is positive, (implemented) startup ideas contribute relatively more to growth.

This concludes the description of our model's equilibrium conditions. Appendix B provides details on its numerical solution. In the next section, we proceed to analyse its quantitative implications.

4 Quantitative Analysis

Our quantitative analysis proceeds in several steps. First, in Section 4.1, we calibrate our model's parameters, matching aggregate and micro-level moments (including several moments introduced in Section 2). In Section 4.2, we review some relevant qualitative properties of the model, and in Section 4.3 we study the relationship between the frequency of acquisitions and aggregate growth. In Section 4.4, we evaluate the effects of an acquisition ban, and in Section 4.5, we discuss several robustness checks.

4.1 Calibration Strategy

We assume that a period of length 1 in the model corresponds to one year in the data. Then, we set several parameters externally. First, we set the discount rate to $\rho = 0.02$ (which, combined with a 2% growth rate, implies a 4% annual interest rate). Second, we set the elasticity of substitution to $\varepsilon = 4$, a standard value in the literature (Aghion, Bergeaud, Boppart, Klenow and Li, 2021; Galí and Monacelli, 2016).

We assume that there are two product quality classes, $\Omega = \{\omega_L, \omega_H\}$ with $\omega_L < \omega_H$. At every point in time, 20% of firms belong to the H class, and their sales account for 80% of GDP (in line with the average industry-level sales share of the top 20% of firms in Compustat). This implies that $\omega_H/\omega_L = 16$. Moreover, we assume that firms transition from ω_H to ω_L at a Poisson rate $\tau = 0.1$, matching the fact that in every year, 10% of Compustat firms belonging to the top 20% of sales in their industry drop out of that category in the subsequent year. We set the elasticity of R&D costs to innovation to $\psi = 2$, following empirical evidence in Akcigit and Kerr (2018). Following David (2020), we set the Nash bargaining parameter for incumbents to $\alpha = 0.5$. Finally, we set the average step size advantage for startup ideas to $\gamma = 0.36$. To obtain this number, we rely on findings from Kogan, Papanikolaou, Seru and Stoffman (2017), who estimate that the elasticity of a patent's market value to its number of forward citations is 0.17. Our results from Section 2.3 indicate that the average startup patent is cited six times as much as the average incumbent patent. Therefore, we assume that a startup patent represents on average $\gamma = 6^{0.17} - 1 \approx 36\%$ more steps than an incumbent patent.

This leaves seven parameters to be identified: the productivity step size, λ; the research and development cost shifters for incumbents, ξ_I and κ_I; the fixed cost of startup creation, ξ_S; the development cost shifter for startups, κ_S; and the scale and curvature parameters in the incumbent's effort cost function, χ and φ. We calibrate these parameters internally using an indirect inference approach: that is, we choose the set of parameter values that minimizes the distance between a set of model-generated moments and their empirical counterparts.[19] The success of this calibration strategy relies on choosing moments that are both relevant for the economic intuitions we want to highlight, as well as sufficiently sensitive to variation in individual parameters. As the model is non-linear, all moments are affected by all parameters, making identification challenging. Nevertheless, we provide economic intuitions for the identification power of different moments, and support these by performing a more rigorous global identification exercise in Appendix B.2.

Precisely, we choose seven moments. First, we target a growth rate of 2%, the long-run growth rate of GDP per capita in the United States (Jones, 2016). This moment identifies the innovation step λ, and we find that an innovation increases productivity by about 5.8%.

Second, we target average outcomes for startups. In the model, startups face three potential outcomes: acquisition, successful own innovation and entry, or failure to innovate and exit. In Section 2.1, we found that around 4% of innovative startups in the United States are acquired. We impose this target, which allows us to identify χ, the search cost of incumbents for startups. The data from Section 2.1 also shows that, conditional on not being acquired, 6.6% of startups either achieve an IPO or manage to grow to more than 100 employees. We interpret these events as successful entry, and therefore impose that on average, non-acquired startups have a 6.6% probability to implement their idea and enter. This moment identifies κ_S, the development cost shifter for startups.

Third, we use our regression evidence from Section 2.4 to set the development cost scale parameter of incumbents, κ_I. Precisely, we match our finding that on average, acquisitions do not affect the implementation probability of startup ideas, by imposing that the average probability to implement an idea is the same for startups and incumbents.[20] As shown in Panel B of Table 3, our calibration implies that the implementation cost of incumbents is about 70% lower than the one of startups. Indeed, with equal implementation costs, our model would imply that incumbents are less likely to implement ideas than startups, due to the replacement effect. To account for the fact that acquisitions do not seem to affect implementation probabilities in the data, our model assigns a large cost advantage to incumbents.

Forth, we target selection into acquisition (on the acquirer side), by matching the sales

[19]Formally, the vector of parameters $\boldsymbol{\theta} = (\lambda, \xi_I, \kappa_I, \xi_S, \kappa_S, \chi, \varphi)$ is chosen to minimize the following criterion distance function: $\sum_{m=1}^{M} \frac{|\text{Moment}_m(\text{Model},\boldsymbol{\theta}) - \text{Moment}_m(\text{Data})|}{0.5|\text{Moment}_m(\text{Model},\boldsymbol{\theta})| + 0.5|\text{Moment}_m(\text{Data})|}$.

[20]That is, we target

$$\sum_{\omega}\sum_{n} m(\omega) \cdot m(n) \cdot i_S(\omega) - \sum_{\omega}\sum_{n} m(\omega) \cdot m(n) \cdot i_A(\omega, n) = 0$$

Table 3: Calibrated parameters and model fit.

A. Externally Calibrated Parameters

Parameter	*Description*	*Value*	*Target/Source*
ρ	Discount rate	0.02	4% annual real interest rate
ε	Elasticity of substitution	4	Standard value
ω_H/ω_L	Relative product quality	16	Top 20% sales share (Compustat)
τ_{HL}	Transition rate from high to low quality	0.10	Likelihood to drop from Top 20% (Compustat)
ψ	R&D cost curvature	2	Akcigit and Kerr (2018)
α	Bargaining weight for incumbents	0.5	David (2020)
γ	Step size advantage of startup ideas	0.36	Kogan *et al.* (2017) and Section 2

B. Internally Calibrated Parameters

Parameter	*Description*	*Value*
λ	Innovation step size	1.058
ξ_S	Startup creation cost	0.074
κ_S	Development cost scale for startups	9.857
ξ_I	Research cost scale for incumbents	0.002
κ_I	Development cost scale for incumbents	2.760
χ	Search cost scale for incumbents	0.700
φ	Search cost curvature for incumbents	2.222

C. Model Fit

Targeted moment	*Model*	*Data*	*Data source*	*Identifies*
Growth rate	2.00%	2.00%	Jones (2016)	λ
Entry rate	5.8%	5.8%	Akcigit and Kerr (2018)	ξ_S
Growth contribution of entrants	25.7%	25.7%	Akcigit and Kerr (2018)	ξ_I
Startup avg. implementation probability	6.6%	6.6%	Section 2	κ_I
Effect of acq. on impl. prob. (percentage points)	0.0	0.0	Section 2	κ_S
Percentage of startups acquired	4.0%	4.0%	Section 2	χ
Relative size of acquiring firms	3.6	2.8	Section 2	φ

difference between acquiring firms and non-acquiring firms. In Section 2.3, we showed that acquirers were about 2.8 times larger than non-acquirers. We target this moment in our model. This identifies the model parameter φ, the curvature in the search cost function, which governs how steeply costs increase for firms that search harder for startups.

Finally, we target both the absolute entry rate as well as the contribution of entrants to overall productivity growth. Both of these moments are not directly observable in our data. We therefore choose targets that are in line with the literature on firm dynamics and innovating firms. Precisely, we follow Akcigit and Kerr (2018), setting an entry rate of 5.8% and imposing that entry accounts for 25.7% of total productivity growth.[21] Note that in conjunction with the other moments, this target for the entry rate implies a target for the startup rate x in our model.[22] This target for the startup rate identifies ξ_S, the cost of startup creation. Finally, while the contribution of entrants to growth is affected by a variety of parameters, it is particularly sensitive to the research costs of incumbents, ξ_I, which shifts the contribution of incumbents' own innovation to growth.

Table 3 lists the calibrated parameter values and summarizes the model fit. With the exception of the size difference between acquiring and non-acquiring firms, the model matches all moments exactly.

4.2 Equilibrium properties

Before turning to the quantitative analysis, we discuss some key properties of the BGP equilibrium in this section (using the calibrated set of parameters).

Figure 5 plots the value function v and the research policy function z for an incumbent firm. Firm value is increasing in quality ω and in the technology gap n. Moreover, firm value is concave in n, as the marginal effect of higher technology gaps on markups and profits gets smaller when the incumbent gets further ahead of its follower. Accordingly, once the incumbent is far ahead enough to charge the unconstrained monopoly markup, firm value no longer depends on the technology gap. The research investment of the firm, in turn, depends on the increments of the value function. Therefore, it is increasing in quality ω, and decreasing in the technology gap n. Note, however, that a firm which has

[21] Akcigit and Kerr (2018) structurally estimate a creative destruction model on the universe of patenting firms in the United States. This focus on patenting firms makes their setup most closely related to ours. However, the influential study of Garcia-Macia, Hsieh and Klenow (2019), which focuses on all firms, finds similar numbers: a 21.1% contribution of entry to productivity growth over our sample period, and an exit rate for "large" firms of 6% (entry and exit rates are equal in our model).

[22] Precisely, the entry rate is the product of the startup rate x, the fraction of startups that are not acquired (96%) and the fraction of non-acquired startups that successfully implement their innovation (6.6%). Thus, an entry rate of 0.058 implies a startup rate of $\frac{0.058}{0.96 \cdot 0.066} \approx 0.915$.

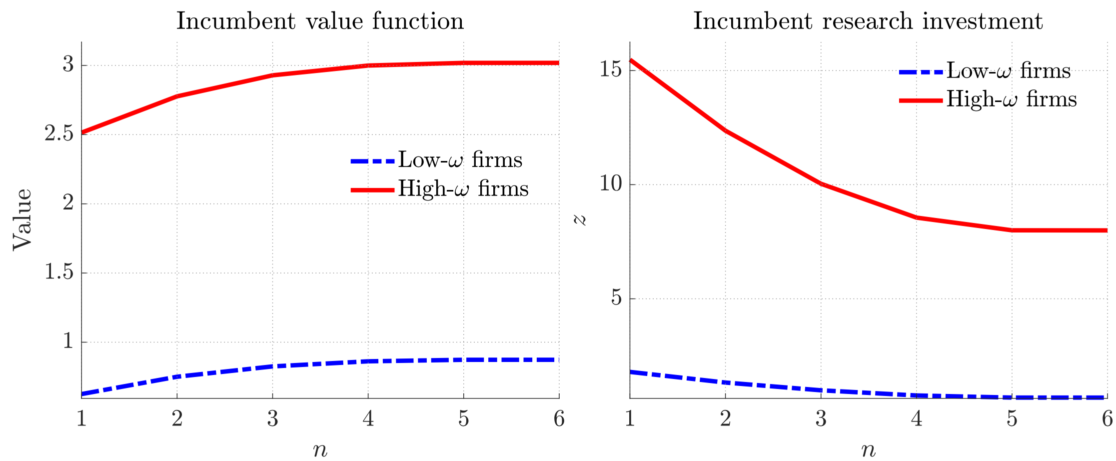

Figure 5: Value functions and research policy functions of incumbent firms, by firm type.

reached the unconstrained monopoly markup still continues to invest into research: even though its markup cannot be increased further, the firm can still increase its market share by increasing productivity.

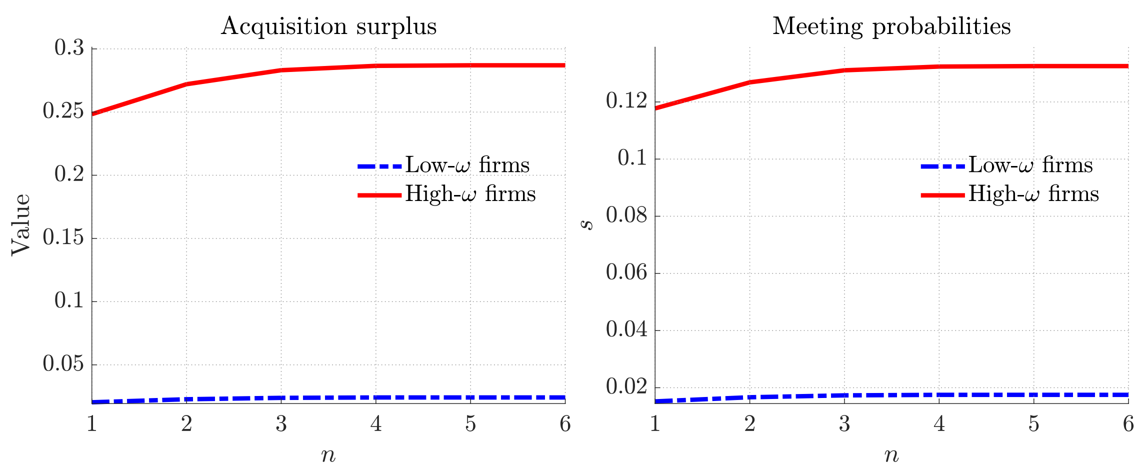

Figure 6: Acquisition surplus and meeting probabilities, by firm type.

Figure 6 plots the acquisition surplus σ and the incumbent meeting probabilities s. In our model, acquisitions may have a positive surplus for two reasons. First, acquisitions could transfer an idea to a more efficient user (as $\kappa_I < \kappa_S$). Second, they allow the technology gap n to remain at least at its current value, instead of being potentially lowered through entry. The first motive reflects a socially useful transfer of ideas, while the second motive just preserves the rents of the incumbent firm (transferring part of them to the startup). A higher product quality ω and a higher technology gap n both imply greater benefits of transferring an idea to a better user and greater rents of maintaining the incumbent's position. Thus, the acquisition surplus is increasing in both variables, and firms with higher quality and higher technology gaps invest more resources into startup search.

Finally, the left panel of Figure 7 plots the implementation probabilities for a startup idea, distinguishing between the case in which the startup is not acquired and invests into implementation itself (i_S), and the case in which the startup is acquired and the incumbent invests into implementation (i_A). As shown in the previous section, incumbents face lower implementation costs than startups. Accordingly, at low levels of the technology gap, incumbents are more likely to implement a startup idea than the startup itself. As the technology gap increases, however, the marginal benefit of innovation for incumbents decreases (as the replacement effect becomes stronger). As a consequence, the implementation probability of ideas for incumbents falls below that of startups, and some acquisitions become killer acquisitions. On average, however, acquisitions do not affect the implementation probability, as imposed by our calibration.

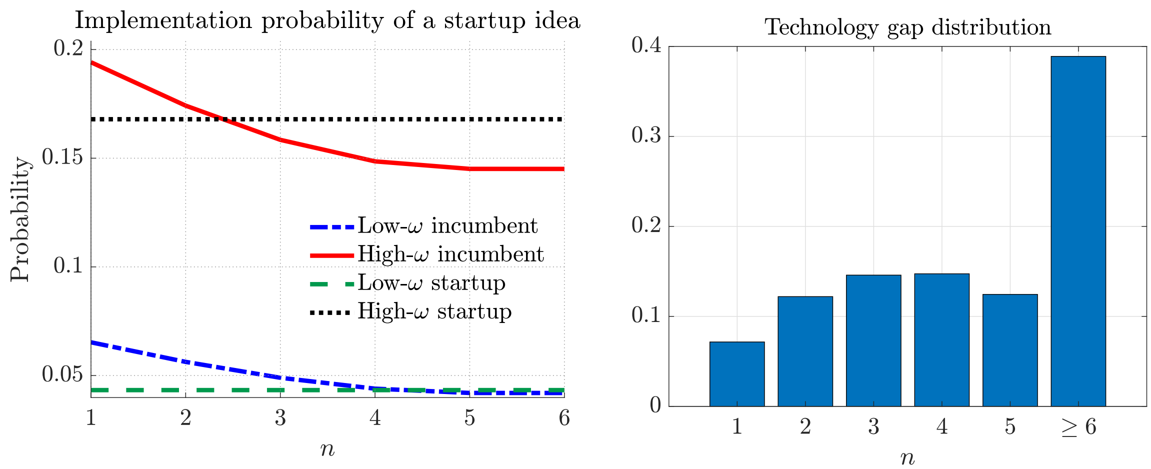

Figure 7: Development probabilities by firm type, and the invariant distribution of technology gaps.

The previous discussion shows that incumbent firm decisions about research, implementation and startup search crucially depend on the technology gap n. Therefore, the distribution of technology gaps across industries, shown in the right panel of Figure 7, is a crucial equilibrium object. This distribution is endogenous, shaped by the innovation choices of incumbents and startups. As we will see in the next sections, prohibiting or encouraging acquisitions will trigger shifts in this distribution.

4.3 The Aggregate Effects of Acquisitions

Comparative statics: the growth rate To study the aggregate effect of acquisitions, we first consider our model's implication for changes in the search cost for startups χ. That is, we solve for the BGP equilibrium for different values of χ, keeping all other parameters at their baseline values. Recall that χ represents frictions in the search for startups: a low value of this parameter implies low frictions and frequent acquisitions, while a high level implies high frictions and infrequent acquisition. Accordingly, as shown in the left panel of Figure 8, the equilibrium frequency of acquisitions is monotonically decreasing in χ.

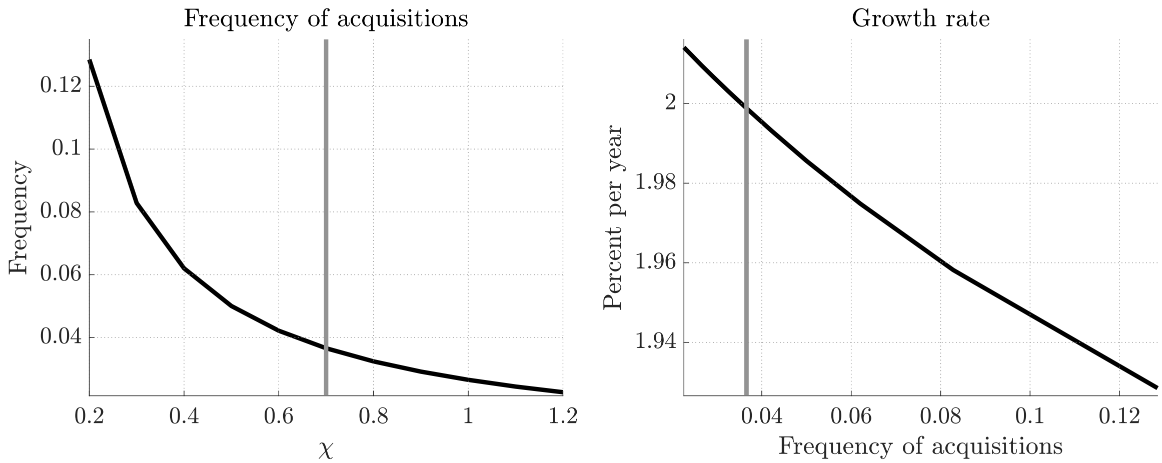

Figure 8: BGP equilibria for different values of search costs χ. The baseline calibration value of χ is marked with a vertical line in the left plot. The right plot shows the reduced-form relationship between the frequency of acquisitions and growth. Again, the vertical line marks the baseline frequency of acquisitions.

The right panel of Figure 8 plots the growth rate of the economy for different values of search costs. Note that for convenience, we plot the growth rate directly against the frequency of acquisitions implied by different search costs.[23] This figure illustrates the main result of our paper: a higher frequency of acquisitions is associated with a lower growth rate.

A useful decomposition Why is the growth rate lower when acquisitions are more frequent? In order to answer this question, we rely on a useful decomposition of the sources of aggregate growth in our model. Indeed, it is easy to show that in our model, the difference in growth rates between different balanced growth paths can be expressed as

$$\begin{aligned}\frac{g}{g^*} =&\sigma_I^* \cdot \frac{\text{Incumbent own innovation}}{\text{Incumbent own innovation}^*} + \\ &(1-\sigma_I^*) \cdot \left(\frac{\text{Startup rate}}{\text{Startup rate}^*} \cdot \frac{\text{Perc. of impl. startup ideas}}{\text{Perc. of impl. startup ideas}^*}\right),\end{aligned} \tag{31}$$

where x* stands for the baseline BGP value of variable x and σ_I^* stands for the BGP share of growth accounted for by incumbents' own innovation. Formally, the variables in

[23]This choice is only to made improve readability: the frequency of acquisitions is obviously an endogenous outcome, and all variation in it is due to underlying variation in the search cost parameter χ.

this decomposition are given by

$$\text{Incumbent own innovation} = \sum_{\omega,n} m(\omega,n) \cdot b_I(\omega,n)$$
$$\text{Startup rate} = x$$
$$\text{Perc. of impl. startup ideas} = \sum_{\omega,n} m(\omega,n) \cdot \Big(\widetilde{s}(\omega,n) \cdot i_A(\omega,n) + \Big(1 - \widetilde{s}(\omega,n)\Big) \cdot i_S(\omega) \Big)$$

Equation (31) shows that any change in the growth rate with respect to its baseline BGP value can be decomposed into three elements: changes in incumbent's own innovation behavior, changes in the startup rate, and changes in the percentage of startup ideas that are implemented. The weights in this expression are given by the baseline BGP share of growth accounted for by incumbents' own innovation. In our baseline calibration, this share is $\sigma_I^* = 72.4\%$.[24]

Decomposing growth Figure 9 uses the decomposition in equation (31) to investigate the sources of the negative relationship between acquisitions and growth. The top left panel plots the three sources of growth identified in the decomposition, normalized to 1 at their baseline BGP level. It shows that when acquisitions increase, the arrival rate of startup ideas increases substantially. Thus, acquisitions have a strong incentive effect on startup creation in our model, which all else equal would imply that they are growth-enhancing. However, this positive effect is more than compensated by a decrease in incumbent's own innovation and in the percentage of startup ideas being implemented.

There are two main reasons for the change in these variables. First, higher acquisitions trigger a composition effect. As the percentage of acquired startups increases more strongly than the startup rate, the entry rate falls in our calibrated model. Creative destruction slows down, and the distribution of technology gaps shifts to the right (as shown in the bottom left panel of Figure 9). At a higher technology gap, the average incumbent has less incentives to invest into research, or to implement its own and startup ideas. Second, a higher startup rate reduces the value of incumbents: even though incumbents can buy out startups and thereby avoid displacement, every acquisition implies a costly sharing of rents with the threatening startup. This decrease in incumbent value contributes to the fall in incumbent innovation, and explains why both incumbents and startups invest less into the implementation of ideas (as shown in the bottom right panel of Figure 9).

[24]Note that the share of growth due to startup ideas (27.6%) is close to the share of growth due to entry (25.7%), which was one of our calibration targets. This is because implementation of a startup idea by an incumbent is a relatively infrequent event with respect to entry (few startups are acquired, and incumbents implement startup ideas at the same rate as startups themselves).

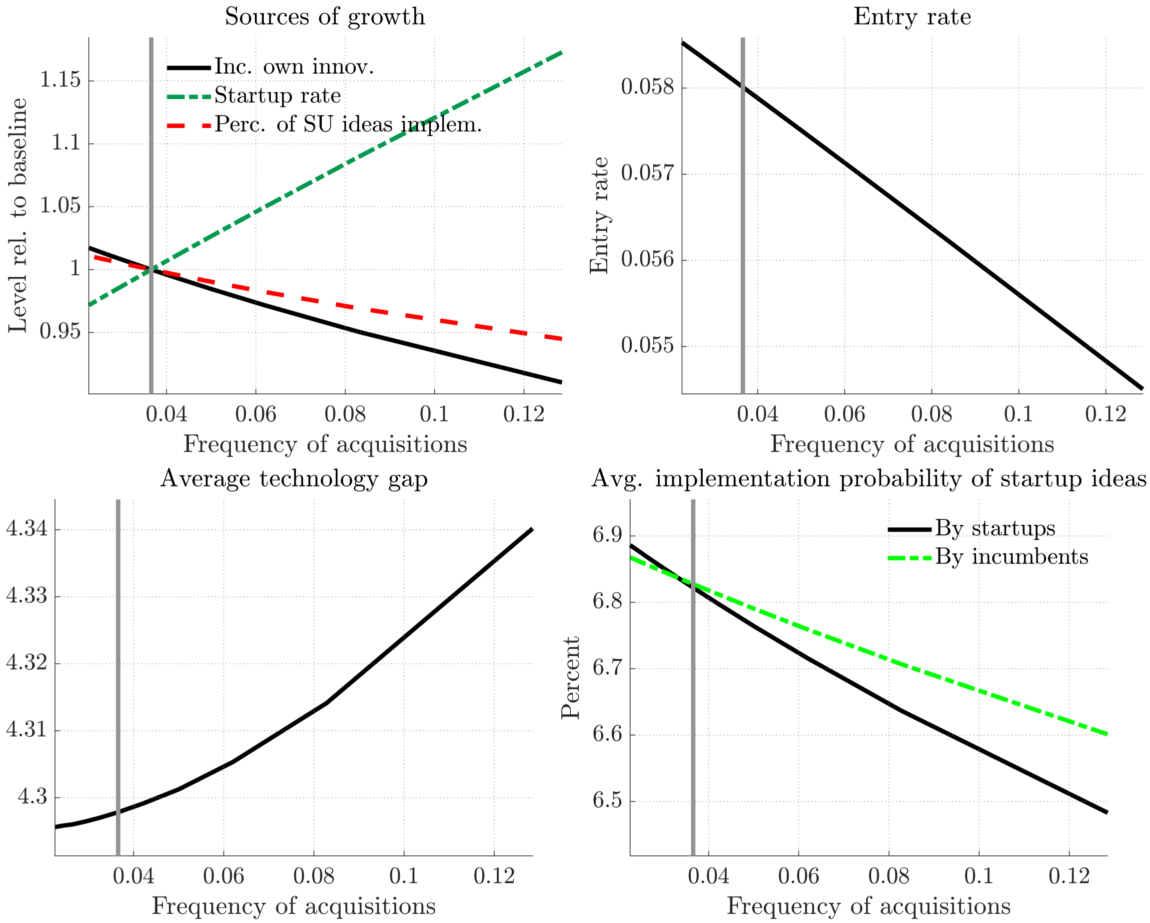

Figure 9: Important equilibrium outcomes for different values of search costs χ. All plots show the frequency of acquisitions on the x-axis (and all variation in this frequency is driven by changes in search costs). The vertical line marks the baseline frequency of acquisitions.

These comparative statics results hint at a positive effect of stricter antitrust policy on growth. To confirm this impression, the next section considers a simple policy experiment.

4.4 Policy: the effects of an acquisition ban

In this section, we consider a simple government intervention that bans all startup acquisitions. Table 4 shows that this policy would lead to a slight increase in the aggregate growth rate, by 0.04 percentage points (or 2.2%) per year. In line with the intuitions developed above, this is the net effect of a 7.6% decrease in the arrival rate of startup ideas and an (overcompensating) 4.8% increase in the own innovation effort of incumbents and a 3.1% increase in the percentage of implemented startup ideas. Banning acquisitions also increases the entry rate and slightly lowers the aggregate markup.

As discussed earlier, there are two reasons for which incumbents' own innovation and the implementation of startup ideas increase after the acquisition ban. First, with greater entry, the technology gap distribution shifts to the left (towards more innovative firms). Second, the disappearance of costly acquisitions increases the value of incumbents. To assess the relative strength of these two channels, we consider a counterfactual accounting exercise in which we only shift the distribution of technology gaps to its post-policy level, but keep all other variables at their baseline levels. This shows that the shift in the distribution alone explains less than 10% of the total growth effect, with the remainder due to changes in incumbent value.

Table 4: The effects of an acquisition ban

Outcome	**Baseline**	**Acq. Ban**	**% Change**
Growth rate	2.00%	2.04%	+2.2%
Incumbent own inn. rate	0.236	0.247	+4.8%
Startup rate	0.917	0.848	−7.6%
Percentage of imp. startup ideas	6.8%	7.0%	+3.1%
Entry rate	0.058	0.059	+2.3%
Percentage of startups acquired	4.0%	0%	−100%
Aggregate markup	22.1%	22.1%	−0.1%

Notes: In this table, we compare our baseline BGP to an alternative “acquisition ban” BGP, in which startup acquisitions are not allowed. To compute the latter equilibrium, we impose that the surplus from acquisitions is always zero (as it would be, for instance, if the government would impose an arbitrarily high tax on startup acquisitions).

Overall, our results in this section suggest that the negative effects of acquisitions on growth are slightly stronger than their positive effects. In the remainder of the paper, we explore the robustness of these baseline results to various different choices for the targeted data moments and the externally calibrated parameters. This provides us with a better sense of the main drivers behind our result.

4.5 Robustness

4.5.1 Do acquisitions always lower growth?

First, it is important to point out that the negative effect of acquisitions on growth is not a foregone conclusion in our model. In fact, a key driver of our baseline result is the fact that incumbents’ own innovation accounts for the bulk of economic growth. Thus, the negative effect of acquisitions on incumbents’ own innovation has a disproportionate effect on the aggregate growth rate.

This implies, in turn, that acquisitions might be growth-enhancing in a situation in which the majority of ideas are generated in startups. Table 5 shows a calibration in which this is the case. This calibration represents a situation in which startups have a large comparative advantage in inventing ideas, but incumbents have a large comparative advantage in implementing them. In that case, acquisitions allow an efficient division of labor between startups and incumbents: startups come up with ideas, and incumbents implement them. As shown in the table, this makes the sign of our results flip: acquisitions are now growth-enhancing, and accordingly, an acquisition ban lowers the growth rate. In the calibration considered here, in which incumbents implement at a rate that is 50 percentage points higher than the one of startups, and half of all startups are acquired, this effect is very large.

Table 5: The effects of an acquisition ban in a “division of labor” equilibrium

Outcome	**Division of labor BGP**	**Acq. Ban**	**% Change**
Growth rate	2.02%	0.94%	−53.4%
Incumbent own inn. rate	0.060	0.133	+120.5%
Startup rate	0.556	0.154	−72.3%
Percentage of imp. startup ideas	34.1%	10.0%	−70.5%

Notes: This table illustrates the effect of an acquisition ban in a “division of labor” calibration. This calibration targets a entry rate of 2%, a growth contribution of entrants of 5%, a 50 percentage point increase in the implementation probability of a startup idea due to acquisition, and imposes that 50% of startups are acquired. All other targets and external parameter values are the same as in the baseline calibration.

This example is admittedly extreme. However, it does help to understand the main drivers of our baseline result: we find a negative effect of acquisitions on growth because incumbents account for the largest share of overall productivity growth, and do not implement ideas at decisively higher rates than startups. The first fact is widely supported by the firm dynamics literature, and the second follows directly from our regression results in Section 2.4. However, it is important to point out that these statements hold for the average industry: thus, there might well be industries which are closer to a “division of labor” equilibrium, and in which acquisitions have therefore a more positive effect.

4.5.2 Robustness checks with respect to parameters

Finally, we explore in this section how our results change when we vary certain key parameters.

Search costs Figure 10 shows the effects of an acquisition ban for different values of search costs χ (leaving all other parameter values unchanged). It shows that in our baseline calibration, the growth effects of an acquisition ban are decreasing in χ (and therefore increasing in the frequency of acquisitions).

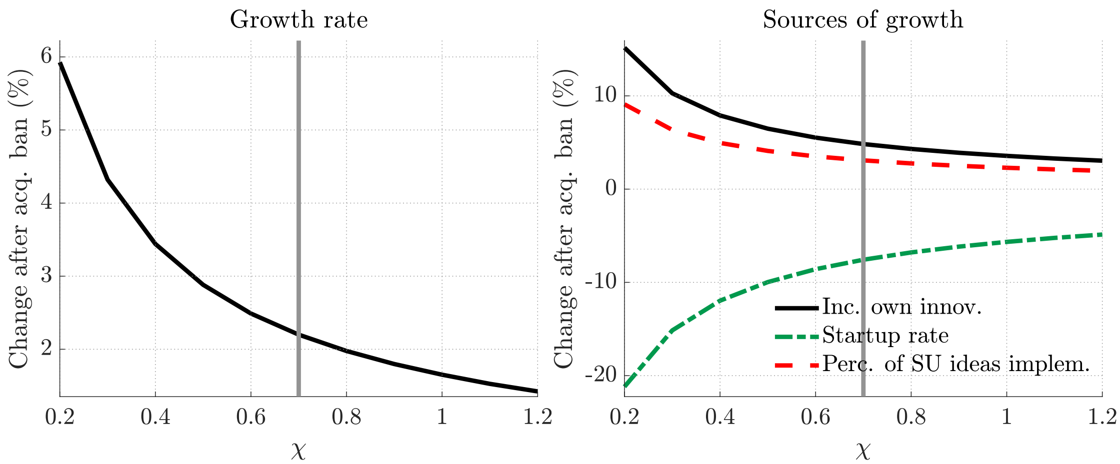

Figure 10: Robustness: the role of χ. This figure shows outcomes for different values of the parameter χ (0.7 in the baseline, as marked by the vertical line). All other parameter values are unchanged.

This suggests that the predictions of our model are monotonic in the frequency of acquisitions: everything else equal, more acquisitions are more harmful to growth.

Incumbent bargaining power Figure 11 shows the effects of an acquisition ban for different values of incumbent bargaining power α (leaving all other parameter values unchanged). The figure shows an inverted U-shape: acquisition bans are most growth-enhancing for intermediate values of incumbent bargaining power. On the other hand, when incumbents have no bargaining power, a ban has no effect, and when incumbents have all the bargaining power, a ban actually reduces growth.

To explain these results, note that when incumbents have no bargaining power ($\alpha = 0$), they have no incentives to acquire startups. Thus, there are no acquisitions, and accordingly, an acquisition ban has no effects. On the other hand, when incumbents have all the bargaining power ($\alpha = 1$), acquisitions are growth-enhancing. This is because incumbents can acquire startups for the lowest possible price in this case. Accordingly, the decrease in the startup rate due to the acquisition ban does not stimulate their innovation much (see the right panel of Figure 11), as startups did not pose a costly challenge to begin with.[25]

[25] Higher bargaining power for incumbents also increases the startup rate, as it gives incumbents greater incentives to search for startups. Even though startups now obtain a smaller share of the surplus, this is more than compensated by the higher rate at which they are acquired.

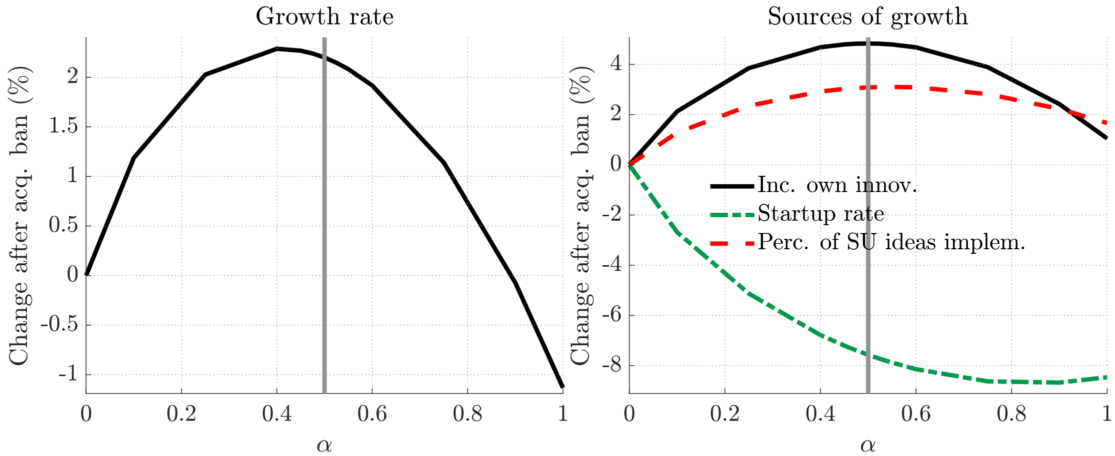

Figure 11: Robustness: the role of α. This figure shows outcomes for different values of the parameter α (0.5 in the baseline, as marked by the vertical line). All other parameter values are unchanged.

Hence, the negative effect of the ban on the startup rate drags the overall growth rate down.

Overall, the robustness checks in this section suggest that the effects of acquisitions depend to an important extent on the characteristics of the initial equilibrium. Given the large variation in circumstances across industries, one would therefore expect antitrust policy to have much stronger effects in some industries than in others.

5 Conclusion

In this paper, we assess the effect of startup acquisitions on productivity growth, using a macroeconomic model that takes into account positive effects (on the startup rate and idea transfers) and negative effects (killer acquisitions and spillovers on incumbents' own innovation incentives). We calibrate the model using micro-level data, and find that higher acquisitions increase the startup rate, by providing additional incentives for startup creation. However, this is more than compensated by a decrease in incumbent's own innovation and in the implementation probability of ideas. Accordingly, a policy that bans all startup acquisitions would increase the rate of growth by around 0.04 percentage points per year.

As our discussion above has shown, our results depend to a large extent to the data we feed into the model. For instance, acquisitions are likely to be more beneficial if startups represent the main source of ideas, but incumbents have decisive development advantages. This suggests that the effects of startup acquisitions could widely differ across industries. Further exploring this industry-level heterogeneity represents a promising path for future research.

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The Aggregate Effects of Acquisitions on Innovation and Economic Growth

by Christian Fons-Rosen, Pau Roldan-Blanco and Tom Schmitz

Appendix Materials

A Derivations and Proofs

A.1 Normalized value functions and free entry condition

Using our guess for the value function, we can rewrite Equations (10) to (14) as

$$v^{\text{NoMeet}}(\omega,n) = (1-i_S(\omega))\cdot v(\omega,n), \tag{A.1}$$

$$v_S^{\text{NoMeet}}(\omega) = \max_{i_S}\left\{ i_S\cdot\left(\sum_{n_S=1}^{+\infty}\theta(n_S)\cdot\lambda^{n_S(\varepsilon-1)}\cdot v(\omega,n_S)\right) - \kappa_S\cdot i_S^{\psi}\right\} \tag{A.2}$$

$$\begin{aligned}\widetilde{\sigma}(\omega,n) = \max_{i_A}\Bigg\{ & v(\omega,n) + i_A\cdot\left(\sum_{n_S=1}^{+\infty}\theta(n_S)\cdot\lambda^{n_S(\varepsilon-1)}\cdot v(\omega,n+n_S) - v(\omega,n)\right) \\ & - \kappa_I\cdot i_A^{\psi}\Bigg\} - v^{\text{NoMeet}}(\omega,n) - v_S^{\text{NoMeet}}(\omega)\end{aligned} \tag{A.3}$$

$$v^{\text{Meet}}(\omega,n) = v^{\text{NoMeet}}(\omega,n) + \alpha\cdot\widetilde{\sigma}(\omega,n) \tag{A.4}$$

$$v_S^{\text{Meet}}(\omega,n) = v_S^{\text{NoMeet}}(\omega) + (1-\alpha)\cdot\widetilde{\sigma}(\omega,n). \tag{A.5}$$

In all of these expressions, lower-case letters denote values that are normalized by relative productivity and aggregate GDP (e.g., $v^{\text{NoMeet}}(\omega,n)\cdot\widetilde{a}^{\varepsilon-1}\cdot Y_t = V_t^{\text{NoMeet}}(\omega,n,a)$, and so on). Using these expressions, we can rewrite the value of a startup - the right-hand side of equation (15) - as

$$\begin{aligned}&\mathbb{E}_t\left[s(\omega,n)\cdot V_{S,t}^{\text{Meet}}(\omega,n,a) + \Big(1-s(\omega,n)\Big)\cdot V_{S,t}^{\text{NoMeet}}(\omega,a)\right] \\ &= \sum_{\omega\in\Omega}\sum_{n=1}^{+\infty}\sum_{a\in\mathbb{A}_t} m(\omega)\cdot m(n)\cdot m_t(a)\cdot\Bigg[s(\omega,n)\cdot v_S^{\text{Meet}}(\omega,n) \\ &\qquad + \Big(1-s(\omega,n)\Big)\cdot v_S^{\text{NoMeet}}(\omega)\Bigg]\cdot\widetilde{a}^{\varepsilon-1}\cdot Y_t\end{aligned}$$

where $\mathbb{A}_t$ stands for the set of all productivities at instant t (note that because productivity evolves on a ladder, this set is always countable), and we have used the fact that the distributions of quality, technology gaps and productivity are independent. This independence allows us to rewrite the value of a startup as

$$Y_t \cdot \sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} m(\omega) \cdot m(n) \cdot \left[s(\omega, n) \cdot v_S^{\text{Meet}}(\omega, n) + \Big(1 - s(\omega, n)\Big) \cdot v_S^{\text{NoMeet}}(\omega) \right] \cdot \left(\sum_{a \in \mathbb{A}_t} m_t(a) \cdot \widetilde{a}^{\varepsilon - 1} \right).$$

Next, note that that by definition,

$$\sum_{a \in \mathbb{A}_t} m_t(a) \cdot \widetilde{a}^{\varepsilon - 1} = \int_0^1 \left(\frac{a_{jt}}{A_t} \right)^{\varepsilon - 1} \mathrm{d}j = 1.$$

Replacing this into the previous expression yields equation (23) in the main text.

A.2 The invariant distribution of technology gaps

To determine the invariant distribution over technology gaps n, we build an *intensity* (also known as *infinitesimal generator*) matrix. For a homogeneous continuous-time Markov chain z_t taking values in some discrete space $\{z_1, z_2, \dots, z_S\} \in \mathbb{R}^S$, a generator matrix $\boldsymbol{M}_z$ is defined by:

$$\boldsymbol{M}_z \equiv \begin{pmatrix} -\sum_{j \neq 1} \lambda_{1j} & \lambda_{12} & \dots & \lambda_{1S} \\ \lambda_{21} & -\sum_{j \neq 2} \lambda_{2j} & \dots & \lambda_{2S} \\ \vdots & \vdots & \ddots & \vdots \\ \lambda_{S1} & \lambda_{S2} & \dots & -\sum_{j \neq S} \lambda_{Sj} \end{pmatrix} \tag{A.6}$$

where $\lambda_{ij} \geq 0$ is the intensity rate for a z_i-to-z_j transition. Note that the diagonal elements of $\boldsymbol{M}_z$ collect outflows, while the off-diagonal elements collect inflows. Thus, each row of an infinitesimal generator matrix must add up to zero.

To build this matrix in our model, we assume $n \in \{1, 2, \dots, n_{max}\}$, i.e. that the technology gap is bounded above by $n_{max} < +\infty$.

We denote by $m_t(n)$ the share of firms in state n at time t. The law of motion of $m_t(n)$ can be written as follows:

$$\frac{\partial \vec{m}_t}{\partial t} = \boldsymbol{M}_n^\top \vec{m}_t \tag{A.7}$$

To find the invariant distribution, we impose $\frac{\partial \vec{m}_t}{\partial t} = \vec{0}$ in equation (A.7) and solve for the unique solution of the system of linear equations holding $\sum_n m(n,k) = 1$.

What are the transition rates? For any transition from n to $n+1$, with $n+1 < n_{max}$, the transition rate is

$$\sum_{\omega} m(\omega) \cdot \left[z(\omega,n) \cdot i_I(\omega,n) + x \cdot \left(\widetilde{s}(\omega,n) \cdot i_A(\omega,n) \cdot \theta(1) + (1-\widetilde{s}(\omega,n)) \cdot i_S(\omega) \cdot \theta(n+1) \right) \right].$$

Transitions occur because of incumbent ideas, 1-step startup ideas implemented by incumbents, and $(n+1)$-step startup ideas implemented by startups.

For transitions from $n_{max}-1$ to n_{max}, the transition rate is

$$\sum_{\omega} m(\omega) \cdot \Bigg[z(\omega, n_{max}-1) \cdot i_I(\omega, n_{max}-1) +$$
$$x \cdot \left(\widetilde{s}(\omega, n_{max}-1) \cdot i_A(\omega, n_{max}-1) + (1-\widetilde{s}(\omega, n_{max}-1)) \cdot i_S(\omega) \sum_{n_S=n_{max}}^{+\infty} \theta(n_S) \right) \Bigg].$$

The intuition is the same as before, but now any startup idea implemented by an incumbent brings us into n_{max}, as well as any startup idea of quality n_{max} or larger.

Next, for transitions from n to $n+k$, with $k > 1$ and $n+k < n_{max}$, we have a transition rate

$$\sum_{\omega} m(\omega) \cdot x \cdot \left(\widetilde{s}(\omega,n) \cdot i_A(\omega,n) \cdot \theta(k) + (1-\widetilde{s}(\omega,n)) \cdot i_S(\omega) \cdot \theta(n+k) \right).$$

These transitions can only occur because of startup ideas allowing an incumbent to take k steps or a startup to take $n+k$ steps.

For transitions from n to n_{max}, with $n < n_{max}-1$, we have

$$\sum_{\omega} m(\omega) \cdot x \cdot \left(\widetilde{s}(\omega,n) \cdot i_A(\omega,n) \sum_{n_S=n_{max}-n}^{+\infty} \theta(n_S) + (1-\widetilde{s}(\omega,n)) \cdot i_S(\omega) \sum_{n_S=n_{max}}^{+\infty} \theta(n_S) \right).$$

These transitions happen when startup ideas allow an incumbent to take $n_{max}-n$ steps or more, or a startup to take n_{max} steps or more.

Finally, for downward transitions, from n_1 to n_2 with $n_1 > n_2$, we have a transition rate

$$\sum_{\omega} m(\omega) \cdot \left(x \cdot (1-\widetilde{s}(\omega,n_1)) \cdot i_S(\omega) \cdot \theta(n_2) \right)$$

Downward transition happen only when there is entry, and the entering startup takes n_2 steps on the quality ladder.

A.3 Aggregate ratios

To obtain equation (24) in the main text, we use the CES price index. The price of the final consumption good holds

$$P_t = 1 = \left(\int_0^1 \omega_{jt} \cdot p_{jt}^{1-\varepsilon} \mathrm{d}j\right)^{\frac{1}{1-\varepsilon}}$$
$$= \sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} \sum_{a \in \mathbb{A}_t} m(\omega) \cdot m(n) \cdot m_t(a) \left[\omega \cdot \mu(n) \cdot w_t^{1-\varepsilon} \cdot a^{\varepsilon-1}\right]$$

As markups are only dependent on n, we can use the fact that $\sum_{\omega \in \Omega} \omega m(\omega) = 1$ and $\sum_{a \in \mathbb{A}_t} m_t(a) \cdot a^{\varepsilon-1} = A_t^{\varepsilon-1}$ to obtain the equation in the main text.

To derive the labor market clearing condition, we first note that the labor demand of each individual firm is

$$l_{jt} = \omega_{jt} \cdot \left(\mu(n_{jt})\right)^{-\varepsilon} \cdot w_t^{-\varepsilon} \left(a_{jt}\right)^{\varepsilon-1} \cdot Y_t.$$

Integrating over all producers and imposing labour market clearing, we get

$$L = \left[\int_0^1 \omega_{jt} \cdot \left(\mu(n_{jt})\right)^{-\varepsilon} \cdot \left(a_{jt}\right)^{\varepsilon-1}\right] \cdot w_t^{-\varepsilon} \cdot Y_t$$
$$= \left[\sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} \sum_{a \in \mathbb{A}_t} m(\omega) \cdot m(n) \cdot m_t(a) \cdot \left(\omega \cdot \left(\mu(n)\right)^{-\varepsilon} \cdot a^{\varepsilon-1}\right)\right] \cdot w_t^{-\varepsilon} \cdot Y_t$$
$$= \left[\sum_{n=1}^{+\infty} m(n) \cdot \left(\mu(n)\right)^{-\varepsilon}\right] \cdot A_t^{\varepsilon-1} \cdot w_t^{-\varepsilon} \cdot Y_t,$$

which immediately yields equation (25) in the main text.

A.4 Growth Rate

As shown in the main text, on the BGP, aggregate output, consumption and wages all grow at the same rate as average productivity A_t. To derive the growth rate of average productivity, we first note

$$\ln(A_t) = \frac{1}{\varepsilon - 1} \cdot \ln\left(\int_0^1 a_{jt}^{\varepsilon-1} dj\right).$$

Now, consider an infinitesimally small time period dt. In this period, every product in state (ω, n) has a probability $b(\omega, n, k) \cdot dt$ of seeing its productivity increase by a factor λ^k, where $b(\omega, n, k)$ is defined as:

$$b(\omega, n, k) \equiv \begin{cases} b_I(\omega, n) + \theta(1) \cdot b_S(\omega, n) & \text{if } k = 1 \\ \theta(k) \cdot b_S(\omega, n) & \text{if } k \geq 2 \end{cases}$$

and (b_I, b_S) are the arrival rates of innovation by incumbents and startups defined in the main text. Therefore, applying the law of large numbers, we can write average productivity at instant $t + dt$ as

$$\begin{aligned}
\ln(A_{t+dt}) = \frac{1}{\varepsilon - 1} \cdot \ln \Bigg[\sum_{a \in \mathbb{A}_t} \sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} m(\omega) \cdot m(n) \cdot m_t(a) \cdot \Bigg(\Bigg(1 - \sum_{k=1}^{+\infty} dt \cdot b(\omega, n, k)\Bigg) \cdot a^{\varepsilon - 1} \\
+ \sum_{k=1}^{+\infty} dt \cdot b(\omega, n, k) \cdot \lambda^{k \cdot (\varepsilon - 1)} \cdot a^{\varepsilon - 1} \Bigg) \Bigg] \\
= \ln(A_t) + \frac{1}{\varepsilon - 1} \cdot \ln \Bigg[\sum_{a \in \mathbb{A}_t} \sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} m(\omega) \cdot m(n) \cdot m_t(a) \cdot \left(\frac{a}{A_t}\right)^{\varepsilon - 1} \\
+ dt \cdot \sum_{a \in \mathbb{A}_t} \sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} m(\omega) \cdot m(n) \cdot m_t(a) \cdot \left(\frac{a}{A_t}\right)^{\varepsilon - 1} \sum_{k=1}^{+\infty} b(\omega, n, k) \cdot \left(\lambda^{k \cdot (\varepsilon - 1)} - 1\right) \Bigg].
\end{aligned}$$

Using again that fact that relative productivity aggregates up to 1, and dividing by dt, we get

$$\frac{\ln(A_{t+dt}) - \ln(A_t)}{dt} = \frac{1}{\varepsilon - 1} \cdot \frac{\ln\left(1 + dt \cdot \sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} m(\omega) \cdot m(n) \sum_{k=1}^{+\infty} b(\omega, n, k) \cdot \left(\lambda^{k \cdot (\varepsilon - 1)} - 1\right)\right)}{dt}.$$

Taking the limit as dt goes to 0 (and using the fact that $\lim_{x \to 0} \frac{\ln(1+x)}{x} = 1$), we get:

$$\frac{\dot{A}_t}{A_t} = \frac{1}{\varepsilon - 1} \cdot \left(\sum_{\omega \in \Omega} \sum_{n=1}^{+\infty} \left[\sum_{k=1}^{+\infty} b(\omega, n, k) \cdot \left(\lambda^{k(\varepsilon - 1)} - 1\right) \right] \right).$$

The term in square brackets is the overall innovation rate in state (ω, n), on average across step sizes. Note:

$$\sum_{k=1}^{+\infty} b(\omega, n, k) \cdot \left(\lambda^{k(\varepsilon - 1)} - 1\right) = b_I(\omega, n) \cdot \left(\lambda^{\varepsilon - 1} - 1\right) + b_S(\omega, n) \cdot \left[\sum_{k=1}^{+\infty} \theta(k) \cdot \left(\lambda^{k(\varepsilon - 1)} - 1\right) \right].$$

Using that $\theta(k) = \frac{\gamma^{k-1}}{(k-1)!} \cdot e^{-\gamma}$ and $\sum_{k=1}^{+\infty} \theta(k) = 1$, we can write the term in brackets from the last expression as follows:

$$\sum_{k=1}^{+\infty} \theta(k) \cdot \left(\lambda^{k(\varepsilon-1)} - 1\right) = e^{-\gamma} \cdot \left(\sum_{k=1}^{+\infty} \frac{\gamma^{k-1}}{(k-1)!} \cdot \lambda^{k\cdot(\varepsilon-1)}\right) - 1$$
$$= \lambda^{\varepsilon-1} \cdot e^{-\gamma} \cdot \left(\sum_{k=1}^{+\infty} \frac{\left(\gamma \cdot \lambda^{\varepsilon-1}\right)^{k-1}}{(k-1)!}\right) - 1$$
$$= \lambda^{\varepsilon-1} \cdot e^{\gamma\cdot(\lambda^{\varepsilon-1}-1)} - 1$$

where, to go from the second to the third line, we note that the term in parenthesis on the second line is equal to $e^{\gamma\cdot\lambda^{\varepsilon-1}}$, as $e^{-\gamma\cdot\lambda^{\varepsilon-1}} \cdot \frac{\left(\gamma\cdot\lambda^{\varepsilon-1}\right)^{k-1}}{(k-1)!}$ equals the probability of a Poisson distribution with parameter $\gamma \cdot \lambda^{\varepsilon-1}$. Putting everything together, we obtain equation (30).

B Numerical Appendix

B.1 Solution Algorithm

To solve for our model's BGP solution, we use the following algorithm.

1. We guess a value for the aggregate productivity-wage ratio, $\frac{A_t}{w_t}$.
2. We guess a value for the startup rate x, and for the distribution of incumbents across technology gaps, $(m(n))_{n\in\mathbb{N}}$.[26]
3. Given these guesses, we solve for the value function of incumbent firms, using the following value function iteration algorithm.
   (a) We guess a value function v.
   (b) Using the first order conditions stated in the main text, we deduce from this guess the policy functions z, s, i_I, i_A, i_S as well as the acquisition surplus σ.
   (c) Using our guess for the distribution $(m(n))$ and our results from (b), we compute the implied value for the growth rate g.
   (d) We use equation (16) to compute a new implied value for the value function, v_{new}.

[26]Note that once the incumbent firm has a technology gap that allows it to charge the unconstrained monopoly markup, the exact value of the technology gap does not matter any more for model outcomes. Therefore, we only need to keep track of the distribution of firms below this threshold, which is a finite object.

(e) If $\| \frac{v - v_{new}}{v_{new}} \|_\infty < 10^{-4}$, the algorithm has converged and we proceed to step 4. If this condition does not hold, we compute a new guess for the value function as $0.998 \cdot v + 0.002 \cdot v_{new}$ and go back to step 3 (b).

4. Compute the value of an entrant v_S (the right-hand side of equation (23)), using our guesses for x and $(m(n))$ and the incumbent policy functions computed in step 3. Then, compute the distribution of technology gaps $(m_{new}(n))$ implied by our guess for x and the innovation rates obtained in step 3. When the condition

$$\min \left(\left| \frac{\xi_S - v_S}{v_S} \right|, \left\| \frac{m - m_{new}}{m_{new}} \right\|_\infty \right) < 10^{-4}$$

holds, we proceed to step 5. Otherwise, we update our guesses for x and $m(n)$ and return to step 3.

5. Using our result for the distribution $m(n)$, we compute the implied value of the productivity-to-wage ratio, using equation (24). When $\left| \frac{\left(\frac{A_t}{w_t}\right)_{new} - \frac{A_t}{w_t}}{\frac{A_t}{w_t}} \right| < 10^{-4}$, the algorithm has converged and we have found the BGP equilibrium. Otherwise, we update our guess for $\frac{A_t}{w_t}$ and return to step 2.

B.2 Estimation Procedure and Global Identification

Next, we explain the estimation procedure and present a global identification test for the calibration exercise presented in Section 4.1.

We seek to find the set of M parameters, collected in the vector $\boldsymbol{\theta}$, that minimizes the distance between M moments generated by the model and their counterparts in the data. The distance function is:

$$\mathcal{D}(\boldsymbol{\theta}) \equiv \sum_{m=1}^{M} \frac{|\text{Moment}_m(\text{Model}, \boldsymbol{\theta}) - \text{Moment}_m(\text{Data})|}{0.5\,|\text{Moment}_m(\text{Model}, \boldsymbol{\theta})| + 0.5\,|\text{Moment}_m(\text{Data})|}$$

To perform such a minimization, rather than relying on gradient-based methods, we use an algorithm that efficiently searches over a large region of the parameter space and searches for the model solution that yields the lowest distance.

In particular, first we create a large M-dimensional hyper-cube $\mathcal{P}$ in the parameter space.[27] Then, we pick quasi-random realizations from it using a Sobol sequence, which

[27] In order to do so, we need to specify bounds for different parameters. In particular, we set a lower bound of 2 for the parameter φ.

successively forms finer uniform partitions of the parameter space. For a sufficiently large number of Sobol draws, this routine efficiently and comprehensively explores every corner of $\mathcal{P}$. For each parameter evaluation, we then solve the model and store its results in a matrix. For this step, we use a high performance computer (HPC), allowing us to parallelize the procedure into hundreds of separate CPUs, thereby saving us an enormous amount of computation time. After N draws (in practice, $N \approx 1.5$ million), we have a $N \times M$ matrix $\boldsymbol{R}$ of results and a $N \times M$ matrix $\boldsymbol{\Theta} \in \mathcal{P}$ of the corresponding parameters. We then select the row vector $\widehat{\boldsymbol{\theta}} \in \boldsymbol{\Theta}$ for which $\mathcal{D}(\widehat{\boldsymbol{\theta}}) \leq \mathcal{D}(\boldsymbol{\theta})$, $\forall \boldsymbol{\theta} \neq \widehat{\boldsymbol{\theta}}$.

The advantage of this method over other estimation techniques is that the model-generated data contained in the $(\boldsymbol{R}, \boldsymbol{\Theta})$ matrices can be exploited to obtain information about identification. Particularly, we implement the following procedure, adapted from Daruich (2020). First, for each parameter p, we select a target moment m which we believe is particularly sensitive to the parameter. Note that, because of the Sobol routine, for each given value of p there is a distribution of values for m resulting from underlying random variation in all the remaining $M - 1$ parameters. Using this fact, we then divide the support of p into 50 quantiles, and compute the 25th, 50th and 75th percentiles of this underlying distribution at each quantile.

We may now study how sensitive m is to changes in p by exploring the properties of how the moment's distribution behaves across different values for p. We say that p is well-identified by m when (i) the distribution changes across quantiles of p, (ii) the rate of this change is high, and (iii) the inter-quartile range of the m distribution is small throughout the support for p. Criterion (i) implies that m is *sensitive* to variation in p, (ii) gives an idea of *how strong* this relationship is, and (iii) implies that *other parameters* are relatively unimportant to explain it. Importantly, as all the remaining parameters are not fixed throughout this analysis but rather are varying in a random fashion, this method gives us a global view of identification and, therefore, presumably outperforms identification methods based on local elasticities (that is, based on moment pseudo-derivatives obtained by keeping the remaining parameters fixed at their calibrated values).

Figure B.1 presents the results from the global identification procedure explained above, where we have associated each targeted moment with the parameter that the moment most plausibly identifies (the same pairing as in Table 3 and in our verbal discussion in Section 4.1). All in all, we find that the parameters of the model are well-identified by criteria (i) and (ii) above and, with some exceptions, by criterion (iii).

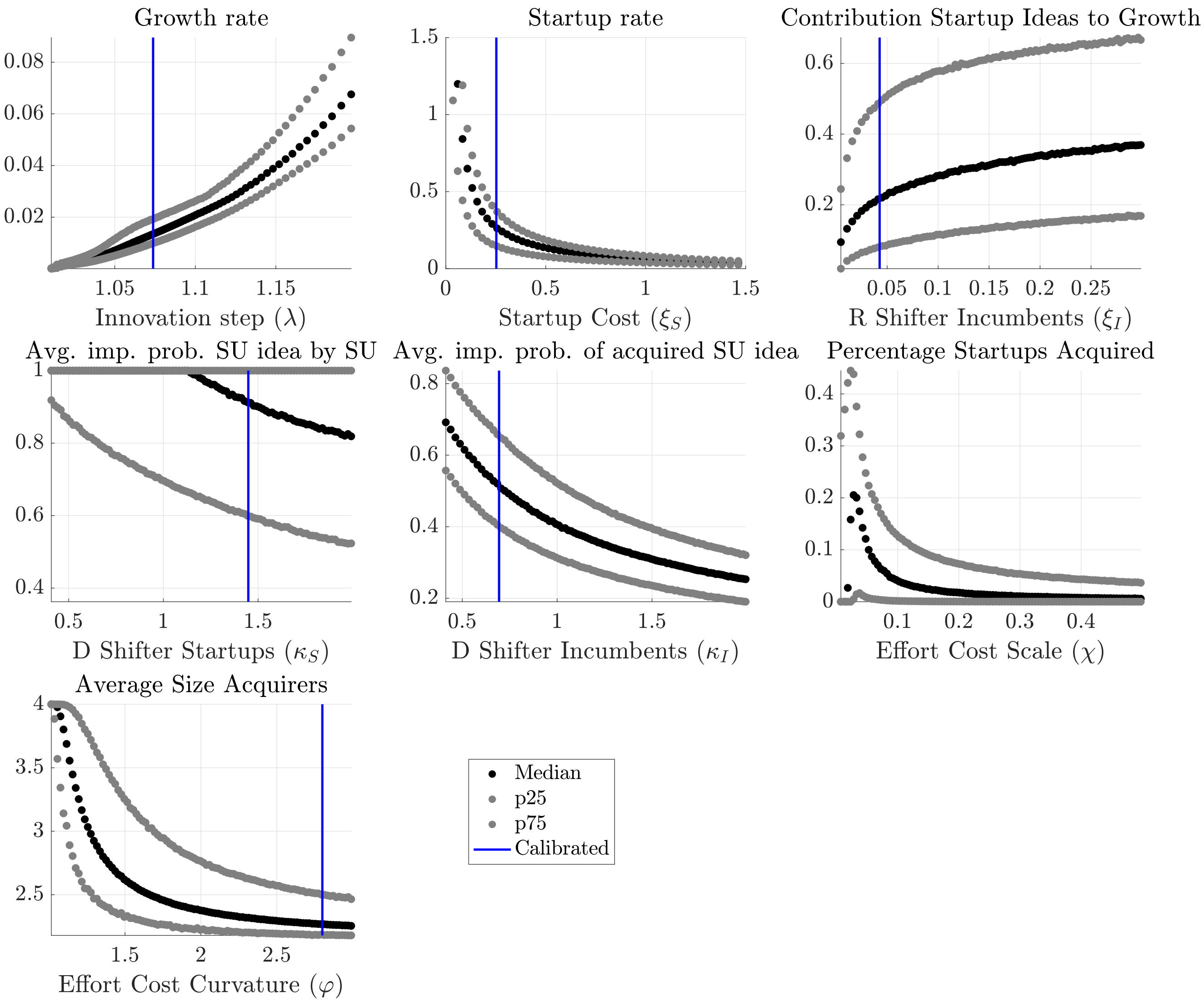

Figure B.1: Global identification results.